

No. 91-886-CFX  
Status: GRANTED

Title: Bob Reves, et al., Petitioners  
v.  
Ernst & Young

Docketed:  
November 27, 1991

Court: United States Court of Appeals for  
the Eighth Circuit

Counsel for petitioner: Elden, Gary M.

Counsel for respondent: Oberly, Kathryn A.

Serv 11/29 NOTE: See mail label re dkt dt future -  
add 33.2(6)

Entry	Date	Note	Proceedings and Orders
1	Nov 27 1991	G	Petition for writ of certiorari filed.
3	Dec 11 1991		Order extending time to file response to petition until January 31, 1992.
5	Jan 31 1992		Brief of respondent Ernst & Young in opposition filed.
4	Feb 5 1992		DISTRIBUTED. February 21, 1992
6	Feb 24 1992		Petition GRANTED. *****
7	Apr 8 1992		Brief amicus curiae of National Assn of Securities and Commercial Law Attorneys filed.
8	Apr 9 1992		Brief amicus curiae of Trial Lawyers For Public Justice filed.
9	Apr 9 1992		Joint appendix filed.
		*	Joint Appendix in two volumes
10	Apr 9 1992		Brief amicus curiae of United States filed.
11	Apr 9 1992		Brief amicus curiae of National Association of Insurance Commissioners filed.
13	Apr 14 1992		Order extending time to file brief of petitioner on the merits until April 17, 1992.
14	Apr 17 1992		Brief of petitioners Bob Reves, et al. filed.
16	Apr 21 1992		Order extending time to file brief of respondent on the merits until May 29, 1992.
17	Apr 24 1992	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
18	May 18 1992		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
19	May 29 1992		Brief of respondent Ernst & Young filed.
20	May 29 1992		Brief amicus curiae of AFL-CIO filed.
21	Jun 1 1992		Brief amicus curiae of American Institute of Certified Public Accountants filed.
22	Jun 5 1992		Record filed.
		*	Original proceedings U.S. District Court, Western District of Arkansas (2 Boxes)
23	Jun 10 1992		Record filed.
		*	Partial proceedings U.S. court of Appeals Eighth Circuit (1 Box)
24	Jun 19 1992	G	Application (A91-952) extension of time within which to file reply brief on the merits, submitted to Justice

No. 91-886-CFX

Entry	Date	Note	Proceedings and Orders
25	Jun 23 1992		Blackmun. Application (A91-952) granted by Justice Blackmun extending the time to file until July 16, 1992.
26	Jul 10 1992		CIRCULATED.
27	Jul 16 1992	X	Reply brief of petitioners filed.
28	Jul 21 1992		SET FOR ARGUMENT TUESDAY, OCTOBER 13, 1992. (1ST CASE).
29	Oct 13 1992		ARGUED.

91-886

FILED

NOV 27 1991

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No.

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IN THE  
SUPREME COURT OF THE UNITED STATES  
OCTOBER TERM, 1991

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BOB REVES, ROBERT H. GIBBS, and FRANCES  
GRAHAM, As Representatives of a Class of  
Note Holders,

*Petitioners,*

v.

ERNST & YOUNG,

*Respondent.*

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PETITION FOR A WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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**QUESTION PRESENTED FOR REVIEW**

Did the Eighth Circuit err when it held, in conflict with other courts of appeals, that the phrase "to conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs" in section 1962(c) of the RICO statute requires proof that the defendant managed or operated the enterprise?

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**OPINIONS BELOW**

The opinion of the U.S. Court of Appeals for the Eighth Circuit is reported at 937 F.2d 1310, and is included in pertinent part in the Appendix at A-1. The summary judgment opinion of the U.S. District Court for the Western District of Arkansas is unreported and is included in pertinent part in the Appendix at A-50.

**JURISDICTIONAL GROUNDS**

On June 27, 1991, the Eighth Circuit affirmed in part and reversed in part the judgment of the district court. On August 29, 1991, the Eighth Circuit denied Ernst & Young's petition for rehearing. This Court has jurisdiction to review the judgment below by writ of certiorari pursuant to 28 U.S.C. § 1254(1). The courts below had federal jurisdiction pursuant to 28 U.S.C. § 1331.

**STATUTE INVOLVED**

The statute involved in this petition is 18 U.S.C. § 1962(c) of the Racketeer Influenced and Corrupt Organizations Act ("RICO"), which provides:

It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

**STATEMENT OF THE CASE**

In 1990, this Court granted our petition for a writ of certiorari in order to determine the proper test for deciding whether or not a particular "note" is a "security." We now ask this Court to resolve a well-developed conflict among the courts of appeal over the level of participation necessary to subject a defendant to RICO liability under 18 U.S.C. § 1962(c).

The petitioners are the members of a Class of small investors (the "Class") who purchased demand notes issued as investment securities by a now-bankrupt farmers' cooperative organization (the "Co-op"). The Class sued certain local employees of Arthur Young & Co., now Ernst & Young (for consistency, "Arthur Young") for, among other things, violating state and federal securities laws and the

Racketeer Influenced and Corrupt Organizations Act ("RICO"). Only the RICO claim is relevant to this petition. In its RICO claim, the Class alleged, among other things, that Arthur Young participated in the conduct of the affairs (especially the ongoing sale of demand notes) of the Co-op (the RICO enterprise) and, in doing so, engaged in a continuous pattern of securities and mail frauds.

Arthur Young became involved with the Co-op in 1980. Over the next several years, it created and perpetuated a fraud that deprived over a thousand investors of millions of dollars. The Co-op raised its operating capital through the sale of uninsured and uncollateralized demand notes to thousands of unsophisticated individual investors. Arthur Young realized that the sale of demand notes was vital to the continued operation of the

Co-op, which at the time was Arthur Young's largest local account. Arthur Young also discovered that the Co-op was insolvent. Faced with this dilemma and hoping that the Co-op could recover over time, Arthur Young devised a scheme to make the Co-op appear solvent in order to allow the Co-op to continue to sell demand notes. The scheme worked for over two years, during which the Co-op sold millions of dollars in largely worthless securities. (See Appendix at A-6 to A-42.)<sup>1</sup>

Arthur Young exercised sole control over the presentation of the Co-op's financial condition to the Co-op's directors, the investors in the demand

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<sup>1</sup> The Eighth Circuit reviewed the facts of this case in great detail, (see Appendix at A-6 to A-44), and we address only the most salient points here.

notes, and the general public. Arthur Young intentionally prepared false financial statements, did not disclose to the Co-op's board of directors the false assumptions used by Arthur Young, knowingly made misleading presentations on the Co-op's financial affairs at the Co-op's annual meetings attended by members and investors, presented false summary reports on the Co-op's financial health at the annual meetings, and concealed its fraud from the Co-op's directors and investors. (See Appendix at A-20 to A-34.)

In 1986, the district court entered summary judgment against the Class on its RICO claim. The court relied on Bennett v. Berg, in which the Eighth Circuit en banc held that section 1962(c) of the RICO statute requires that a defendant have "some participation in the

operation or management of the enterprise itself."<sup>2</sup> The district court concluded that Arthur Young's activities did not "satisfy the degree of management required by Bennett v. Berg." (See Appendix at A-58 to A-60.)<sup>3</sup>

In 1987, after a five-week trial on the securities claims, the jury concluded that Arthur Young had "originated" a fraud and ran it for two

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<sup>2</sup> 710 F.2d 1361, 1364 (8th Cir.) (en banc) (citation omitted), cert. denied, 464 U.S. 1008 (1983).

<sup>3</sup> In ruling against the Class, the district court also relied on the Eighth Circuit's formulation of RICO's "pattern" requirement at that time, Superior Oil Co. v. Fulmer, 785 F.2d 252 (8th Cir. 1986). (See Appendix at A-61 to A-78.) This Court expressly rejected Superior Oil in H.J. Inc. v. Northwestern Bell Tel. Co., 492 U.S. 229 (1989), however, and the Eighth Circuit's most recent decision in this action was not based on any failure to comply with the "pattern" requirement.

and a half years. The jury decided that Arthur Young was liable to the Class for approximately \$6.1 million in compensatory damages. On appeal, Arthur Young contested its liability under the securities laws, while the Class argued that the entry of summary judgment against its RICO claim was in error, particularly in light of Arthur Young's commission of a series of securities frauds over nearly three years.

In 1988, the Eighth Circuit overturned the jury's award, concluding that the Co-op's notes were not securities (and thus never reaching the RICO issue because it held there were no predicate acts). In 1990, this Court reversed the Eighth Circuit's decision, holding that the court of appeals had applied an incorrect legal standard and that the

Co-op's demand notes were securities. 494 U.S. 56, 110 S. Ct. 945.

In 1991, on remand, the Eighth Circuit issued a lengthy opinion affirming the judgment against Arthur Young on the Class' federal and state securities claims. The court expressly stated that it was not formulating a broad theory of accountant liability: "We certainly doubt that other accounting firms will engage in the type of conduct that Arthur Young did in this case. More particularly, we hope that Arthur Young will not." 937 F.2d at 1333.

The court of appeals also affirmed the district court's grant of summary judgment against the Class' RICO claim, holding that it had no choice but to follow the Eighth Circuit's decision in Bennett: "We are aware of the inconsistencies between the circuits

regarding the necessary level of participation for RICO liability. . . . But until the Supreme Court rejects our standard or this court en banc overrules Bennett, we are bound to follow that decision." 937 F.2d at 1324; Appendix at A-47 to A-48.

## REASONS FOR GRANTING THE WRIT

### I. INTRODUCTION

The RICO statute provides for liability for those who "conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs." 18 U.S.C. § 1962(c). In determining the level of participation necessary for RICO liability, the courts of appeals have formulated three distinct and inconsistent tests. The Eighth Circuit, as well as the D.C. Circuit, require proof that a RICO defendant in some manner managed or operated the enterprise. This test conflicts directly with the test that has been adopted in the Second, Third and Ninth Circuits, the test that is employed in the Fifth, Sixth and Seventh Circuits, and the approach of the Eleventh Circuit.

Had the Class' claim been scrutinized under any test other than the Eighth Circuit's, the Class would have been able to present its RICO claim to the jury. The Eighth Circuit's participation test is inconsistent with the language and purposes of the RICO statute and should be rejected. In doing so, this Court should announce the proper test, which then can be applied by all the circuits.

II. THIS COURT SHOULD RESOLVE THE CONFLICT AMONG THE COURTS OF APPEALS AND DETERMINE THE LEVEL OF PARTICIPATION NECESSARY FOR RICO LIABILITY.

Over the past twelve years, the courts of appeals have formulated three different tests for determining the level of participation in the conduct of a RICO enterprise's affairs that can give rise to

a violation of section 1962(c).<sup>4</sup> The Class believes that both the Second Circuit's test and the Fifth Circuit's test are consistent with RICO's language and purposes.

According to the Second Circuit's test, the "participation" element is present where "(1) one is enabled to commit the predicate offenses solely by virtue of his participation in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise."<sup>5</sup> The

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<sup>4</sup> See D. Abrams, The Law of Civil RICO § 4.7.3, at 232-42 (1991).

<sup>5</sup> United States v. Scotto, 641 F.2d 47, 54-55 (2d Cir. 1980), cert. denied, 452 U.S. 961 (1981).

Second Circuit's test has been adopted by the Third and Ninth Circuits.<sup>6</sup>

If the Second Circuit's test governed this action, the Class would be entitled to present its RICO 'claim to a jury. There is at least a genuine issue of material fact as to whether (1) Arthur Young was able to commit the predicate acts of securities fraud by virtue of its involvement in the financial affairs of the Co-op, or (2) the predicate acts of fraud were related to the conduct of the Co-op's demand note investment program.'

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<sup>6</sup> United States v. Yarbrough, 852 F.2d 1522, 1544 (9th Cir.), cert. denied, 488 U.S. 866 (1988); United States v. Provenzano, 688 F.2d 194, 200 (3d Cir.), cert. denied, 459 U.S. 1071 (1982).

<sup>7</sup> In its securities law analysis on remand, the Eighth Circuit held that "Arthur Young 'materially aided' in the sale of the demand notes." 937 F.2d at 1326.

The second "participation" test originated in the Fifth Circuit. According to that test, where the enterprise is a legitimate business, the "participation" element of section 1962(c) requires that "(1) the defendant has in fact committed the racketeering acts as alleged; (2) the defendant's position in the enterprise facilitated his commission of the racketeering acts; and (3) the predicate acts had some effect on the lawful enterprise."<sup>8</sup> The Fifth Circuit test has been followed by the Sixth and Seventh Circuits.<sup>9</sup>

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<sup>8</sup> United States v. Cauble, 706 F.2d 1322, 1333 (5th Cir. 1983), cert. denied, 465 U.S. 1005 (1984).

<sup>9</sup> United States v. Pieper, 854 F.2d 1020, 1026 (7th Cir. 1988); United States v. Qaoud, 777 F.2d 1105, 1115 (6th Cir. 1985), cert. denied sub nom. Callanan v. United States, 475 U.S. 1098 (1986).

Again, the Class would at least reach a jury under the Fifth's Circuit's test. First, it now is settled that Arthur Young committed a series of acts constituting securities fraud. Second, there is ample evidence that Arthur Young's position as auditor of the Co-op facilitated its commission of the securities frauds. Third, it is beyond dispute here that Arthur Young's fraud had "some effect" on the Co-op's ability to continue its demand note investment program.

The third test is the one that actually was applied to defeat the Class' RICO claim. The Eighth Circuit's test, as stated in Bennett, requires that a RICO defendant must "participat[e] in the 'operation or management of the enterprise

itself.'"<sup>10</sup> The D.C. Circuit, sitting en banc, recently rejected the Second Circuit and Fifth Circuit tests and adopted the Eighth Circuit's test; the D.C. Circuit concluded, "In order to participate in the conduct of an enterprise's affairs . . . a person must participate, to some extent, in 'running the show.'"<sup>11</sup>

The Class believes that the practical effect of the Eighth's Circuit test is that in two courts of appeals, accountants and other outsiders associated with an enterprise almost never can be subject to RICO liability; though outsiders may use an enterprise as a vehicle through which to commit a pattern

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<sup>10</sup> 710 F.2d at 1364.

<sup>11</sup> Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639, 913 F.2d 948, 954 (D.C. Cir. 1990) (en banc), cert. denied, 111 S. Ct. 2839 (1991).

of illegal acts, they probably will not direct the day-to-day operations of the enterprise. In contrast, accountants and other outsiders not directly involved in "running the show" of the enterprise, but who use their involvement in the enterprise to perpetrate a pattern of illegal acts, may be subject to RICO liability in seven other circuits.

The Eleventh Circuit has expressly rejected the Eighth Circuit's "management or operation" test in a case that is indistinguishable from this case.<sup>12</sup> In Bank of America v. Touche Ross & Co., 782 F.2d 966, 970 (11th Cir. 1986), the court stated flatly, "It is not necessary that a

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<sup>12</sup> The Eleventh Circuit has not yet expressly adopted either the Second Circuit or the Fifth Circuit test. See United States v. Carter, 721 F.2d 1514, 1527 & n.16 (11th Cir.), cert. denied, 469 U.S. 819 (1984).

RICO defendant participate in the management or operation of the enterprise." Thus, the Eleventh Circuit held that the plaintiff stated a valid cause of action under RICO against the defendant accounting firm, which allegedly assisted in preparing and disseminating false financial statements that induced banks to lend money to the enterprise. Here, Arthur Young's activities went far beyond those of the accountants in Bank of America.

The Bank of America decision directly conflicts with the decision below and shows that in determining the presence of RICO's "participation" element, the courts of appeals have reached inconsistent results under essentially the same circumstances. Whether an accounting firm may ever be liable under RICO should not depend on whether the audit is

conducted in Arkansas or Alabama. This Court therefore should intervene and decide the proper test to be applied by all courts of appeals.

III. THIS COURT SHOULD REJECT THE EIGHTH CIRCUIT'S TEST.

This Court should reject the Eighth Circuit's "management or operation" test, which is contrary to the plain language of section 1962(c), inconsistent with the stated purposes of the RICO statute, and incompatible with this Court's dictum in H.J. Inc..

The language of section 1962(c) is broad enough to subject to RICO liability those defendants who are associated with, but not necessarily employees of, an enterprise and who participate, even indirectly, in the conduct of the enterprise's affairs. See 18 U.S.C. § 1962(c). There is nothing in this provision that requires any degree of management or operation; indeed, the statute expressly includes those who

"conduct" the enterprise's affairs and also those who "participate," whether "directly or indirectly," in conduct of these affairs.<sup>13</sup> In rejecting the "multiple scheme" restriction that the Eighth Circuit had formulated for RICO cases, this Court stated that those words "appear nowhere in the language or legislative history."<sup>14</sup> Likewise, the Eighth Circuit's test here wrongly would read the words "management or operation"

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<sup>13</sup> Admittedly, the RICO statute is not a model of legislative draftsmanship. Perhaps the most obvious example is that the word "conduct" appears in section 1962(c) as both a noun and a verb. Nevertheless, in each instance the meaning of the word is apparent from the context in which it is used.

<sup>14</sup> H.J. Inc., 492 U.S. at 240-41.

into the plain language of the RICO statute.<sup>15</sup>

Furthermore, the Eighth Circuit's test is inconsistent with this Court's instruction that "RICO is to be read broadly" in keeping with "Congress' self-consciously expansive language and overall approach." Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 497-98 (1985). As this Court has recognized, "Congress drafted RICO broadly enough to encompass a wide range of criminal activity, taking many different forms and likely to attract a broad array of perpetrators operating in

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<sup>15</sup> See, e.g., United States v. Garner, 837 F.2d 1404, 1420 (7th Cir. 1987) ("RICO does not require that the defendants actually manage or operate the enterprise. This court's decisions have held squarely that a RICO defendant need not have a supervisory position in order to violate section 1962(c)." (citations omitted)), cert. denied, 486 U.S. 1035 (1988).

different ways." H.J. Inc., 492 U.S. at 248-49. Accordingly, the RICO statute contains a direction to construe the statute's provisions liberally in order to effectuate the remedial purposes of the statute. 18 U.S.C. § 1961 note (84 Stat. 947).

Moreover, the Eighth Circuit's test appears to be inconsistent with this Court's dictum in H.J. Inc.. There, the plaintiffs alleged that the defendant, Northwestern Bell, had engaged in a pattern of bribing the members of the Minnesota Public Utilities Commission ("MPUC"). This Court stated that the plaintiffs, at trial, might be able to demonstrate a threat of continuity of racketeering activity by showing that the alleged bribes were Northwestern Bell's "regular way of conducting or participating in the conduct of the

alleged and ongoing RICO enterprise, MPUC."<sup>16</sup>

Significantly, the Court did not anticipate that the plaintiffs would need to prove that Northwestern Bell managed or operated the MPUC in some manner, and indeed, it seems unlikely that the plaintiffs in H.J. Inc. could ever meet that standard. Here, the level of participation that Arthur Young had in the conduct of the Co-op's financial affairs was at least as deep as the participation that Northwestern Bell allegedly had in the conduct of the MPUC's regulatory affairs.

Under the Eighth Circuit's view, almost any outsider to an enterprise can escape RICO liability. Yet the liability

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<sup>16</sup> H.J. Inc., 492 U.S. at 250.

of outsiders who participate in an enterprise's affairs is becoming an increasingly important issue in criminal and civil cases arising out of the failure of other financial institutions. Accountants and other outsiders who stray far beyond their appointed roles to originate frauds and injure investors should not be granted virtual immunity from RICO.

#### CONCLUSION

The Class therefore asks this Court to reject the Eighth's Circuit's test for the RICO "participation" element; announce a test that is consistent with the words and purposes of the RICO statute; reverse the grant of summary judgment against the Class' RICO claim;

and remand this action for further proceedings.

Respectfully submitted,

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## APPENDIX

A-1

UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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ARTHUR YOUNG & CO.,

Appellant,

v.

BOB REVES; ROBERT H. GIBBS; FRANCES GRAHAM,

Appellees.

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THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS, and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellants,

v.

ARTHUR YOUNG & CO.,

Appellee.

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A-2

THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

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THOMAS E. ROBERTSON, JR., etc., et al.

v.

JACK WHITE, et al.

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THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

A-3

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THOMAS E. ROBERTSON, JR., etc., et al.

v.

JACK WHITE, et al.

---

ROBERT R. CLOAR, Class Counsel,

Appellant,

v.

BOB REVES,

Appellee.

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Nos. 87-1726WA, 87-1727WA,  
87-1083WA, 87-2533WA and  
88-1014WA

Submitted March 12, 1991

Decided June 27, 1991

[Reported at 937 F.2d 1310]

Before FAGG and MAGILL,  
Circuit Judges, and SNEED,<sup>1</sup>  
Senior Circuit Judge.  
MAGILL, Circuit Judge.

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<sup>1</sup> THE HONORABLE JOSEPH T. SNEED,  
Senior Judge, United States Court of  
Appeals for the Ninth Circuit, sitting by  
designation.

Arthur Young appeals from the district court's entry of judgment against it after a jury found that the firm had violated both federal and state securities laws.<sup>2</sup> On appeal, Arthur Young argues that the district court erred in (1) certifying the plaintiff class; (2) holding that the financial instruments at issue in this case were securities under Arkansas law; (3) denying its motion for judgment

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<sup>2</sup> This appeal is before us on remand after the Supreme Court reversed our earlier decision that the financial instruments at issue in this case were not federal securities. See Reves v. Ernst & Young, 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990), rev'g Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1990). We had ruled that the instruments were not federal securities under the test from SEC v. W.J. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). See 856 F.2d at 55. The Supreme Court, however, declined to apply the Howey test, and instead applied the Second Circuit's "family resemblance" test, see, e.g., Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976), to conclude that the instruments were securities under federal law. 110 S.Ct. at 952.

notwithstanding the verdict on the state and federal securities claims; and (4) denying its motion for a new trial on the ground that a requested instruction on contribution was not given to the jury. Arthur Young also argues that the damages awarded to the appellees were not supported by the evidence and challenges the district court's awards of attorney fees, costs, and interest to the appellees. On cross-appeal, Reves and Robertson challenge a number of the district court's rulings, including its dismissal of Robertson's breach of contract claim, its granting of summary judgment in favor of Arthur Young on Reves' RICO claim, its crediting of settlement proceeds against the jury's verdict, and its decision on fees for Reves' counsel. We affirm in part and reverse in part.

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I.

A. The Co-op

The facts of this case involve the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op), which was organized in 1946 and operated in western Arkansas and eastern Oklahoma. Any farmer in the area could become a member, and as a member was entitled to one share and one vote. Each year the Co-op's members elected twelve of their own to serve on a Board of Directors. The Board met monthly to review the Co-op's operations, but delegated actual management of the Co-op to a general manager, whom the Board appointed. In 1952, the Board named Jack White as general manager. White served in that capacity until the Board removed him in mid-1982.

To raise money for its operating expenses, the Co-op sold promissory notes payable to the holder on demand. These

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demand notes, while uncollateralized and uninsured, were nonetheless attractive to investors because they paid a higher interest rate than that local financial institutions offered. The Co-op advertised the demand note program in its monthly newsletter as an "Investment Program." The advertisement stated the rate of interest the notes would earn and claimed: "YOUR CO-OP has more than \$11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] Insured but it is . . . Safe . . . Secure . . . and available when you need it. Interest is computed to the day of withdrawal." See, e.g., Joint Appendix (JA) at 1820 (ellipses in original).

## B. The Gasohol Plant

In 1979, the Co-op's general manager, White, joined with entrepreneur Edwin Dooley to finance and construct a gasohol plant. Dooley and White each invested \$125,000 of their own funds and as a result each owned half of the enterprise, which was known as Big D & W Refining and Solvents, Inc. Dooley served as president of the corporation; White was its secretary. Construction of the plant began in June 1979. Four months later, White, financed by a loan from the Citizens Bank & Trust Company (Citizens Bank), purchased Dooley's interest in Big D & W and renamed the company White Flame Fuels, Inc. (White Flame).

Beginning in January 1980, White obtained loans from the Co-op to finance the continued construction and the initial operation of the gasohol plant. White

personally guaranteed these loans. The plant finally began producing gasohol the following April, but was soon beset by problems stemming from the plant's poor design and outside economic factors. White continued to obtain loans from the Co-op; by December 1980, these loans totalled approximately \$4 million.

In September 1980, White was indicted for federal tax fraud. The indictment charges, among other things, that White had engaged in a course of self-dealing with the Co-op and had filed fraudulent tax returns. Also indicted with White was Gene Kuykendall, the Co-op's longtime accountant, who was also White Flame's accountant at this time.

Shortly after the indictment, at a November 12, 1980, Board meeting, White proposed that the Co-op purchase White Flame. The Board agreed and voted to

acquire the company. One month later, however, the Co-op filed a declaratory action against White and White Flame in state court. The complaint had been drafted by White's attorneys, and alleged that on February 15, 1980, White had told the Board that all of White Flame's stock would be transferred to the Co-op in exchange for the Co-op's assumption of White's debts to the Co-op and Citizens Bank.<sup>3</sup> The complaint alleged that in reliance on this agreement, the Co-op invested further sums in White Flame, based on the assumption that it owned the company. The complaint next alleged that White did not transfer the stock as agreed,

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<sup>3</sup> The minutes of the Co-op Board Meeting for February 15, 1980, do not contain any references to the Co-op acquiring the stock of White Flame. JA at 933. In fact, the first reference to the Co-op purchasing White Flames does not occur until the minutes of the November 12, 1980, Board meeting. JA at 1070.

and that the Co-op had not executed a note assuming White's debts to Citizens Bank. Based on these allegations, the Co-op sought a declaratory judgment stating that the Co-op had acquired White Flame on or about February 15, 1980; that the Co-op had assumed Jack White's debt to Citizen's Bank; that all amounts to the Co-op lent to Jack White or White Flame before February 15, 1980, were investments in White Flame; and that Jack White was discharged from any debts to the Co-op relating to White Flame.

Shortly after the complaint was filed, White's attorneys sent the Co-op's attorney, Carl Creekmore, White's answer and a proposed consent decree. Creekmore filed the answer and obtained the state court's approval of the decree on December 19; but the decree was not filed until January 26, 1981. The decree

provided that the Co-op had owned White Flame since February 15, 1980; that the Co-op had assumed White's debt to Citizen's Bank; and that White was discharged from any liability to the Co-op for loans for White Flame. The result of this friendly suit was that White was relieved of over \$4 million of debt and that the Co-op owned White Flame as of February 15, 1980.

#### C. The 1981 Audit

Both White and Kuykendall were convicted of tax fraud in January 1981.<sup>4</sup>

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<sup>4</sup> This court affirmed these convictions in United States v. White, 671 F.2d 1126 (8th Cir. 1982). The evidence in the criminal case showed that White had engaged in a course of self-dealing with the Co-op, and that he and Kuykendall had cooked the Co-op books and filed fraudulent tax returns to cover up White's activities. We concluded: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts. . . ." Id. at 1134.

Testifying on White's behalf at the criminal trial was Harry Erwin, the managing partner of Russell Brown and Company, Arkansas' largest accounting firm at that time.<sup>5</sup> Shortly after White's conviction, his lawyer contacted a member of Russell Brown and stated that the Co-op was interested in hiring the firm. In June 1981, Jack White and Kirit Goradia, the Co-op's office manager, met with Erwin and Joe Drozal, another member of Russell Brown. Later that year the Co-op hired Russell Brown to perform the Co-op's 1981 audit. Joe Drozal was named the partner in

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<sup>5</sup> On January 2, 1982, Russell Brown merged with Arthur Young and Company. After the merger, Erwin was placed in charge of Arthur Young's Arkansas practice. Later, Arthur Young and Company became Ernst & Young. For the sake of consistency with the earlier opinions in this case, future references will be to "Arthur Young."

charge; Joe Cabaniss was selected to assist him.

After beginning the 1981 audit process in early 1982, Drozal became aware that there were problems concerning how White Flame should be treated for accounting purposes. In a January 26, 1982,<sup>6</sup> memo, Drozal raised several problems relating to the valuation and acquisition of White Flame. He observed that White Flame's records contained no detailed documentation of cost or expense allocations. Drozal also specifically noted that the Co-op's audited financial statement for 1980 had disclosed the Co-op's full ownership of White Flame, but had not disclosed that the Co-op had forgiven

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<sup>6</sup> Russell Brown had merged with Arthur Young by this time. See supra note 4.

the \$4 million in loans White had personally guaranteed. JA at 1189-1191.

One of Drozal's first tasks in the audit was to determine White Flame's fixed asset value. Drozal realized that he could not rely on the fixed asset value provided for White Flame in the 1980 financial statement because Kuykendall, a convicted felon, had prepared that statement. Therefore, Drozal had to determine it on his own. One way of determining fixed asset value is to add the asset's construction costs to its capitalized expenses. Drozal knew there was a problem with White Flame's reported capitalized expenses, because Jack White had told him that because the plant was only producing at 20% of capacity, they had included only 20% of their production costs as expenses; the remaining 80% of the production costs were added to the fixed asset value of the

plant. Drozal's superior at Arthur Young informed him that only those costs should be added to the plant's value. JA at 1215; 9 Tr. at 236. Drozal's investigation into the treatment of the production costs was limited mainly to talking with Jack White, and reviewing the construction costs and capitalized expenses reported in White Flame's books, which Drozal knew that Kuykendall had prepared. 9 Tr. at 186.<sup>7</sup> Drozal concluded, based primarily on information provided by convicted felons, that the plant's value at the end of 1980 was \$4,393,242.66, exactly the same figure Kuykendall had calculated. JA at 1219. Using this figure as a base, Drozal factored in the 1981 construction costs and

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<sup>7</sup> Kuykendall testified that he fabricated these numbers on White's direction and attempted to cover up the scheme by slightly varying the percentages of costs expensed. 7 Tr. at 258.

capitalized expenses, and concluded that White Flame's 1981 fixed asset value was approximately \$4.5 million. Id.

Once Drozal determined White Flame's fixed asset value, he had to determine how that value should be treated for accounting purposes. This involved examining the circumstances of the Co-op's acquisition of White Flame. If the Co-op had owned White Flame from the beginning of construction in 1979, White Flame's value for accounting purposes would be its fixed asset value, \$4.5 million. If the Co-op had purchased White Flame from Jack White, however, then White Flame's value for accounting purposes would be its fair market value at the time of purchase. Moreover, if the Co-op had purchased White Flame from White, the transaction would have to be closely scrutinized, because White was an officer of the Co-op. Drozal

concluded that the Co-op had owned White Flame from the beginning, and thus that the plant should be valued at \$4.5 million. He based this conclusion on the Co-op's having lent White funds for the plant's construction and operation; that White was supervising the construction and operation; and that the court decree stated that all of the Co-op's loans to White had been investments in the plant. 9 Tr. at 224. Drozal believed that characterizing White Flame as having always been owned by the Co-op reflected "economic reality." Id.

In concluding that the Co-op had always owned White Flame, Drozal ignored a great deal of information suggesting exactly the opposite. For example, although he relied on the court decree's statement that the Co-op's loans to White were really investments, Drozal ignored that part of the decree that stated that

the Co-op had acquired White Flame on February 15, 1980. He ignored the facts that White Flame's tax returns indicated that it was owned by Jack White and Edwin Dooley; that each had initially invested \$125,000 in White Flame; that White had eventually bought Dooley out; that White had always personally guaranteed the loans he received from the Co-op; and that the Co-op's 1979 audit contained no mention of White Flame. Drozal never talked with Dooley, with any 1979 or 1980 Board members, with the Co-op's lawyer, or with the Co-op's previous auditor.

By concluding that the Co-op had always owned White Flame, Drozal was able to avoid applying auditing standards that required a closer look at the actual acquisition and was also able to avoid having to value the plant at its fair market value. The advantage of reaching

this conclusion was clear: Drozal knew that if White Flame were valued at less than \$1.5 million, the Co-op's net worth for 1981 would have been wiped out. 10 Tr. at 41.<sup>8</sup> Drozal also knew that bad news about the Co-op's financial condition could provoke a run on the demand notes and thus deprive the Co-op of its primary source of funds. 9 Tr. at 189.

D. The 1981 Audit Report to the Board

On April 22, 1982, Arthur Young<sup>9</sup> presented its 1981 audit report to the Co-

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<sup>8</sup> One expert witness testified at trial that as of December 31, 1981, White Flame was not economically viable, and that its liquidation value was \$500,000 to \$700,000. 4 Tr. at 97. Another expert, who used a more sophisticated appraisal method, testified that White Flame's fair market value at the end of 1981 was between \$444,000 and \$1.5 million. 4 Tr. at 184. Arthur Young did not attempt to rebut this testimony.

<sup>9</sup> See supra note 4.

op's Board of Directors. Arthur Young concluded that with two exceptions, the Co-op's consolidated financial statements fairly presented the Co-op's financial position. The relevant exception stated that Arthur Young had "some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations," JA at 235. The firm explained: "Management has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated factual statements." Id.

The financial statements attached to the audit report listed the Co-op's assets at \$20,869,300. Included in this total was \$4,522,086 for the gasohol plant.

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The Co-op's liabilities totaled \$18,246,743, including \$12,164,007 in unredeemed patron demand notes. The Co-op's net worth was \$2,622,557. The financial statement's Note 9 addressed White Flame. The note stated, in relevant part:

Financing of the initial construction and subsequent revisions which totaled approximately \$4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately \$5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging \$100,000 per month) until such time that improvements in market conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investments in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of

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a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

JA at 251-52.

Arthur Young did not tell the Board that it concluded that the Co-op had always owned White Flame and thus was able to value the plant at \$4.5 million. 9 Tr. at 227. Nor did it tell the Board that if the Co-op had purchased White Flame, as opposed to owning it from the beginning, there might be a net worth problem. Moreover, Arthur Young never specifically asked the Board or the Co-op's management for projections as to the operations of White Flame. 10 Tr. at 57-58.

E. The 1982 Annual Meeting

On May 27, 1982, the Co-op held its annual meeting. Approximately 350 people attended. At the meeting, the Co-

op distributed condensed financial statements that purported to convey the economic health of the organization.<sup>10</sup> The condensed financial statement for 1981 stated that the Co-op's assets were \$20,869,300 and that its liabilities were \$18,246,743, leaving the Co-op with a net worth of \$2,622,557. JA at 1231. The statement included White Flame's \$4.5 million asset value in its total assets, but did not include White Flame's \$1.2 million loss. The statement also failed to include any of the information about White Flame's status found in Note 9 of the audit report.

The condensed financial statement also contained the annual meeting's agenda. Listed as giving the financial report was

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<sup>10</sup> The Co-op prepared these statements based on Arthur Young's audit report and the accompanying financial statement.

"Harry C. Erwin, C.P.A., ARTHUR YOUNG & COMPANY." JA at 1241. Also present from Arthur Young was Joe Cabaniss. Erwin received the two condensed financial statements when he arrived at the meeting. He had no advance preparation as to the statement's contents. As he began his presentation, Erwin informed the members that they had condensed statements and that copies of the full audit were at the Co-op's offices. Erwin then started to discuss the condensed statement. The audience soon began asking questions about the acquisition of White Flame and its financial status. When asked how much money White Flame had lost, Erwin responded that it was a separate corporation under federal law. Erwin was also asked how the Co-op had acquired White Flame and responded that he thought the Board had voted to acquire it. During these

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interchanges, White Flame's \$1.2 million loss was disclosed to the audience. The meeting began to get very heated, with the audience asking many questions about White Flame and other items in the condensed statement. As the questions increased in both frequency and intensity, Erwin was unable to respond and the Board moved the meeting on.

The result of Erwin's five-minute presentation was that the audience knew that the Co-op owned White Flame and that the plant had \$1.2 million in losses. However, Erwin did not disclose the following: Arthur Young's conclusion that the Co-op had always owned White Flame; that as a result of this conclusion White Flame was valued at \$4.5 million; the material in Note 9 of the full financial statement; that Arthur Young had qualified its audit opinion; that Arthur Young could

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not satisfy itself as to the proper carrying value of White Flame; or that a write-down of White Flame to its fair market value would wipe out the Co-op's net worth. 12 Tr. at 112-13.

#### F. The 1982 Audit

The Co-op also hired Arthur Young to perform the 1982 audit. Erwin and Drozal were again Arthur Young's point men. Joe Cabaniss was again selected to work with Drozal and prepared a background memo on the 1982 audit. JA at 1234. The memo classified the Co-op as a "close monitoring client," i.e., a client that might pose some type of risk to Arthur Young. The memo also addressed issues of particular importance for the Co-op's audit. These included the recoverability of the gasohol plant and the condensed financial statements for 1981. As regards the

gasohol plant, Cabaniss, before talking to Drozal, believed its acquisition involved a related party transaction, and hence that the Co-op had not always owned it. Cabaniss also expressed his doubts as to whether the gasohol plant could ever make money. As regards the condensed financial statements, Cabaniss noted:

At the annual meeting the patrons are provided with condensed financial statements. Last year they were given a consolidated balance sheet and a Co-op only income statement which did not reflect the equity in the earnings (loss) of White Flame. We should advise the client of this misleading presentation and find an acceptable manner of presentation.

JA at 1240.

Arthur Young proceeded with the audit. Standard auditing procedures require the auditor to obtain a client representation letter. This letter, drafted by the auditor, but signed by the client's chief executive and financial

officers, states that the client's financial records are accurate and consistent with generally accepted accounting principles. The Co-op's letter for the 1982 audit was signed by Fred Howard, who had replaced Jack White as the Co-op's General Manager. Kirit Goradia, the Co-op's office manager, who essentially functioned as its chief financial officer, did not sign the letter. In the space provided for signing one's name, Goradia wrote: "My only response is attached herewith not as part of this letter." JA at 1245. The attachment stated: "This is to state that during the course of your 1982 audit of books and records of [the Co-op and White Flame], I have not intentionally withheld any information from you." JA at 1246. Goradia told Cabaniss that he did not want to sign the letter because if something happened later, he did

not to be accused of wrongdoing. 11 Tr. at 140. Normally, when a company's chief financial officer refuses to sign a representation letter, the auditor is supposed to disclaim the audit opinion or issue an adverse opinion. Id. at 142. Arthur Young, however, did not believe that Goradia had refused to sign the letter, and thus did neither.<sup>11</sup>

G. The 1982 Audit Report to the Board

Arthur Young presented its 1982 audit report to the Board on March 7, 1983. The 1982 report was substantially similar to the 1981 report. Arthur Young again stated that "there is some doubt as to the

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<sup>11</sup> Arthur Young did not get a signed client representation letter for the 1981 Co-op audit either. When asked about this at trial, Cabaniss responded: "Now, the year before, we thought we had that sucker, and . . . we believed we had it. There was no reason to even think it had been refused." 11 Tr. at 142.

recovery of the investment in [White Flame] and its continuing operation. Management has not prepared projections and other analyses to assess the potential recovery of this investment." JA at 258. Arthur Young again concluded: "Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statement." Id. Arthur Young's concerns were more fully explained in Note 8 to the financial statement, which was basically the same as the 1981 audit report's Note 9.

The 1982 financial statement reported that the Co-op had assets of \$17,127,986 and liabilities of \$15,741,240, resulting in a net worth of \$1,386,746. The gasohol plant was listed as an asset worth \$4,537,520.

## H. The 1983 Annual Meeting

The Co-op's 1983 annual meeting was held on March 24 of that year. Sometime before the meeting Goradia and Cabaniss discussed the Co-op's condensed financial statements. Cabaniss told him that Arthur Young's name should not be on the condensed statement because the statement would be misleading without the explanatory notes. Shortly before the meeting Cabaniss and Drozal received a copy of the condensed statement, which stated in boldface letters across the top of the page: "The following financial information was condensed from Arthur Young & Company's Annual Audit." JA at 1248. Drozal and Cabaniss saw that Arthur Young's name was on the statement and that Note 8 was omitted, but said nothing to Goradia. 11 Tr. at 149.

The annual meeting's program stated that the financial report would be given by Arthur Young. Cabaniss began the financial report by informing the audience that they possessed condensed statements, and that full audit reports were at the Co-op's offices. He knew as he began that the condensed statement was misleading because it did not contain the explanatory notes to the audit. Id. at 150. The presentation lasted three minutes. Cabaniss did not tell the audience that the report was misleading. He did not tell them about Note 8, that Arthur Young was unable to satisfy itself as to White Flame's value, or that if White Flame was written down to its fair market value the Co-op might be in financial trouble. At that time, White Flame's stated value after depreciation was approximately \$3.5 million. The Co-op's net worth was \$1.3

million. If the plant has been written down to less than \$2.2 million, the Co-op's net worth would have been wiped out.<sup>12</sup>

#### I. Bankruptcy

The demand note program was not the Co-op's only source of funds. It also received loans and lines of credit from the Cooperative Finance Association (CFA), which was owned by Farmland, a regional supply cooperative. William Moon, a vice-president of CFA, had informed the Co-op that because of its reliance on demand notes, if the amount of invested notes dropped below \$9.5 million, CFA would cut off the Co-op's line of credit. In the fall of 1983, CFA advanced the Co-op a \$5.78 million line of credit to finance its grain inventory and operations. 3 Tr. at

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<sup>12</sup> See supra note 5 for the experts' appraisals of White Flame's value.

46. In February of 1984, representatives of the Co-op met with CFA to arrange more financing. 12 Tr. at 12. Later that month the Co-op had a slight run on the demand notes. Id. The Co-op asked CFA for the money on its line of credit to protect itself from further runs. Id. CFA, because total demand note investments had dropped below \$9.5 million, decided not to advance the Co-op any of the \$800,000 the Co-op had remaining on its line of credit. 3 Tr. at 161. The Co-op then filed bankruptcy proceedings on February 23, 1984, to protect itself from a run on the demand notes. 12 Tr. at 13. In the subsequent bankruptcy disclosure statement, which the bankruptcy court approved on September 4, 1984, the Co-op asserted that three factors caused its bankruptcy: (1) ineffective management; (2) using demand notes as the primary source of

financing; and (3) the financial problems of White Flame. AY Ex. 223. The result of the bankruptcy filing was that the demand notes were frozen in the bankruptcy estate, and thus were no longer redeemable at will by the noteholders.

#### J. Trial

After the Co-op filed for bankruptcy, it remained as debtor in possession until October of that year, when the bankruptcy court appointed Thomas Robertson as trustee. On February 14, 1985, Robertson, on behalf of the Co-op and certain demand noteholders, filed suit against forty individuals and entities, including members of the Co-op's Board, the Co-op's lawyers, Jack White, Kirit Goradia, Gene Kuykendall, and Arthur Young. On September 27, 1985, the district court certified a class of noteholders consisting

of people who purchased demand notes between February 15, 1980, and February 23, 1984, naming Bob Reves, Frances Graham, and Robert Gibbs the class representatives.<sup>13</sup> Robertson thus no longer represented the Class, but only the Co-op. Before trial, Robertson and the Class settled with all defendants except Arthur Young and Jack White's legal representatives.<sup>14</sup>

Robertson and the Class asserted seven claims against Arthur Young. Four of these claims are relevant to this appeal: (1) Robertson's claim that Arthur Young breached its auditing contract with the Co-op because the firm did not perform its audits in accordance with generally accepted accounting principles and auditing

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<sup>13</sup> Future references to the noteholders will be to the "Class."

<sup>14</sup> Subsequent to trial, Robertson and the Class settled with White's lawyers as well.

standards; (2) the Class' claim that Arthur Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5; (3) the Class' claim that Arthur Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of Arkansas securities law; and (4) Robertson's and the Class' claim that Arthur Young was a material participant in the operation and management of the Co-op, in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68. Arthur Young then cross-claimed against the Co-op's Board of Directors seeking contribution.

Before trial, the district court dismissed Robertson's action for securities fraud and Robertson's and the Class' breach

of contract claim. See Robertson v. White (Robertson I), 633 F. Supp. 954, 974, 976 (W.D. Ark. 1986). The district court also determined before trial that the demand notes were securities under both federal and Arkansas law. See Robertson v. White (Robertson, II), 635 F. Supp. 851, 865 (W.D. Ark. 1986). Arthur Young then moved for summary judgment on Robertson's and the Class' RICO claim, which the district court granted. See Robertson v. White (Robertson III), Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 116 (W.D. Ark. Oct. 15, 1986).

Trial commenced on October 22, 1986, and lasted approximately a month. Robertson's and the Class' witnesses consisted mainly of Board members, accounting, legal, and appraisal experts, and Arthur Young personnel. Arthur Young's witnesses consisted mainly of Board

members, a legal expert, and two state court clerks.<sup>15</sup> After trial, the jury found that Arthur Young had committed both state and federal securities fraud.<sup>16</sup>

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<sup>15</sup> While reviewing the trial transcript after oral argument, we noticed that Board member Larry Heatherington, who was not listed in the transcript's table of contents, did testify. See 2 Tr. at 201-40. We also noticed that at least one part of the trial was not transcribed, namely, the closing argument of counsel for Jack White's law firm. See 16 Tr. at 130-33. Because of our concern with the integrity of the transcript, we requested counsel for Arthur Young and the Class to provide us with a list of the witnesses who testified. Robertson's list, which Arthur Young agreed was accurate, does not include Heatherington. We can only conclude that both parties relied on the transcript's various tables of contents. As a result, we still have reservations about the trial transcript's accuracy. Because apparently neither of the parties share our reservations, we will treat it as accurate.

<sup>16</sup> Although not relevant to the issues on appeal, we note that the jury also found that Arthur Young negligently performed the Co-op's 1981 and 1982 audits, that the Co-op was contributorily negligent, and that Arthur Young had not committed common-law fraud in its performance of those audits.

The jury found that the Class' damages as a result of the fraud totaled \$6,121,652.94.

After the jury returned the verdict, the district court asked the parties to make all motions that might affect the judgment. Responding to these motions in a post-trial memorandum, the district court decided that sums the Class had already received as a result of settlements should offset the jury's verdict. See Robertson v. White (Robertson IV), Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 37 (W.D. Ark. Feb. 5, 1987). The district court also denied Arthur Young's motions for judgment notwithstanding the verdict (JNOV) on the state and federal securities claims. Id. at 49, 61. Finally, the district court rejected Arthur Young's argument that the

court wrongly denied the firm's contribution claim. Id. at 54.

The district court's final judgment as regards Arthur Young was as follows:

Arthur Young is ordered to pay to the Class \$6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claim) and costs, under both state and federal claims, subject to a credit in the amount of \$5,774,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities law claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Court, after allowing credits and determining fees, interest and costs.

Amended Judgment Order, Nos. 85-2044, 85-2096, 85-2155, 85-2259 (W.D. Ark. Apr.

23, 1987). Arthur Young, the Class, and Robertson appealed the various judgments, rulings and orders.

#### K. Subsequent History

This case first came before us in 1988. See Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1988). At that time we reversed the district court's judgment on the threshold issue of whether the demand notes were securities under the federal or Arkansas law, holding that they were not. See id. at 55. Subsequently, the Supreme Court vacated our opinion and reversed, holding that the notes were securities within the meaning of § 3(a)(10) of the Securities Act of 1934, codified at 15 U.S.C. § 78c(a)(10) (1988). See Reves v. Ernst & Young, 494 U.S. 56, 110 S.Ct. 945, 953, 108 L.Ed.2d 47 (1990). On remand, we

now address the plethora of issues the parties originally raised on appeal.

## II.

### A. Class Certification

[Text Omitted]

### B. Robertson's Breach of Contract Claim

[Text Omitted]

### C. The RICO Claim

[4] The Class argues that the district court improperly granted summary judgment in favor of Arthur Young on its RICO claim. The Class alleged in its complaint that Erwin, Drozal, and Cabaniss conducted or participated in the affairs of the Co-op, committing both mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c), which provides: "It shall be unlawful for any person employed

by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity. . . ."

Summary judgment is proper where, viewing the evidence in the light most favorable to the nonmoving party, and giving that party the benefit of all reasonable inferences to be drawn from that evidence, the movant is entitled to judgment as a matter of law. See Agristor Leasing v. Farrow, 826 F.2d 732, 734 (8th Cir. 1987). Viewing the evidence in the light most favorable to the Class, we agree with the district court that, as a matter of law, Arthur Young's involvement with the Co-op did not rise to the level required for a RICO violation. In Bennett v. Berg,

710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008, 104 S.Ct. 527, 78 L.Ed.2d 710 (1983), we addressed the nature of the participation required of a RICO defendant before liability is appropriate: "A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." Id. at 1364. Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings. In the course of this involvement it is clear that Arthur Young committed a number of reprehensible acts, but these acts in no way rise to the level of participation in the management or operation of the Co-op.

The Class contends that we should follow the Eleventh Circuit's decision in Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co., 782 F.2d 966 (11th Cir. 1986), where that court stated that it "is not necessary that a RICO defendant participate in the management or operation of the enterprise." Id. at 970. We are aware of the inconsistencies between the circuits regarding the necessary level of participation for RICO liability. See Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639, 913 F.2d 948, 952-55 (D.C. Cir. 1990) (en banc) (reviewing the varied approaches to the participation requirement taken by the Second, Fourth, Fifth, Seventh, Eighth and Eleventh Circuits and adopting the Eighth Circuit's standard), cert. denied, \_\_\_\_ U.S. \_\_\_\_, 111 S.Ct. 2839, 115 L.Ed.2d 1007 (U.S. June 17, 1991). But until the

Supreme Court rejects our standard or this court en banc overrules Bennett, we are bound to follow that decision. Therefore, we conclude that the district court properly granted summary judgment in favor of Arthur Young on the Class' RICO claim.

D. Demand Notes and Arkansas Law

[Text Omitted]

E. The State Securities Fraud Claim

[Text Omitted]

F. The Rule 10b-5 Claim

[Text Omitted]

H. The Damages

[Text Omitted]

I. The Settlement Credit

[Text Omitted]

J. Conclusion

[Text Omitted]

III.

A. Interest

[Text Omitted]

B. Costs

[Text Omitted]

C. Fees

[Text Omitted]

D. Class Counsel

[Text Omitted]

E. Conclusion

[Text Omitted]

IV.

[Text Omitted]

IN THE UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF ARKANSAS  
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the  
Farmer's Co-op of Arkansas & Oklahoma,  
Inc.; BOB REVES; FRANCES GRAHAM, ROBERT H.  
GIBBS, individually; ROBERT H. GIBBS, as  
natural guardian of his minor children,  
THOMAS A. GIBBS and ROBERT H. GIBBS, JR.;  
and ROBERT H. GIBBS, as Trustee of the  
Muskogee Internal Medicine Group Profit  
Sharing Funds,

Plaintiffs,

v.

JACK E. WHITE, ET AL.,

Defendants.

Consolidated Cases No. 85-2044,  
85-2096, 85-2155, 85-2259  
H. Franklin Waters, Chief Judge

MEMORANDUM OPINION  
FILED OCTOBER 15, 1986

I. INTRODUCTION

In Robertson v. White, 633 F.Supp.  
954 (W.D. Ark. 1986) we tested the legal  
sufficiency of the plaintiffs' consolidated  
complaint. We tried to make it clear at

that time that our purpose was to determine  
which allegations could sustain a cause of  
action under the most liberal and indulgent  
construction. Even so, the court was  
greatly troubled by certain of the  
plaintiff's claims. We suggested that some  
of them may very well have been barred by  
the statutes of limitations. Instead of  
dismissing them at that point, we advised  
the parties that we would rule on the  
questions later, in connection with motions  
for summary judgment. In addition, we  
expressed reservations about the  
applicability of certain causes of action  
to the parties. In this connection, we  
were doubtful that R.I.C.O. questions could  
be raised against the work of auditors,  
based on dicta in Bennett v. Berg 710 F.2d  
1361 (8th Cir. 1983). The passage of time  
has brought with it two recent Eighth  
Circuit civil R.I.C.O. decisions which

raised for our consideration vexing questions whether any of the defendants had been shown to have operated an enterprise "through a pattern" of racketeering activity. See, Fulmer v. Superior Oil Co., 785 F.2d 252 (8th Cir. 1986) and Holmberg v. Morrisette, Civ. 85-5138 (8th Cir., slip op., Sept. 3, 1986). That the court of appeals for our circuit would overturn two verdicts, the factual findings of which are to be deemed controlling unless "clearly erroneous" FRCP, Rule 52(b), indicates to us that the court to whom we are immediately responsible has developed and is developing a requirement for pattern fundamentally more rigorous than one which it suggested might be appropriate in Alexander Grant v. Tiffany Industries, 770 F.2d 717, 718 n.1 (8th Cir., 1985). Those who thirst for consistency in the law can find their solace in the fact that

Alexander Grant explicitly said that it was not passing on the sufficiency of a showing of pattern in its decision, was judging (as we did) only the sufficiency of a pleading, and, coming a year before Fulmer and Holmberg, can hardly be said to be the final word on the topic. It may be possible that our system of notice pleading will permit still more R.I.C.O. cases to enter discovery, since "pattern", unlike fraud, may not have to be specifically pleaded. It is probable, therefore, that cases under a Rule 12 examination will continue to confuse the resolution of motions arising under Rule 56. The sufficiency of the plaintiffs' case is here today subjected to a more rigorous screening than the one which we pursued a half a year ago. In that connection, too, the rules for decision have changed. Whereas formerly the Eighth Circuit

enjoined that motions under Rule 56 be denied if even the "slightest doubt" was present, Traylor v. Black, Sivalis, and Bryson, 189 F.2d 213 (8th Cir., 1951); now the trial courts are admonished to enter judgment against parties where no reasonable jury could find for them on the best construction of facts submitted in support of their case. Anderson v. Liberty Lobby, Inc., 54 U.S.L.W. 4755 (June 23, 1986). We do not sit as triers of fact, and make no credibility determinations, since under our Constitution, that lies with the province of the jury. U.S. Const., Amendment 7. Rather, we determine whether, for example, the plaintiffs' evidence, if believed, suffices, to present a factual question subject to resolution by a jury. If not, we enter judgment for the moving party, as we did for plaintiffs on their securities law claims a few months

earlier. Robertson v. White, 635 F. Supp. 851 (W.D. Ark. 1986).

If it appears to the professional reader that the court is writing far too pedantically, we plead guilty and offer by way of explanation our hope that members of the press, who will read this opinion and broadcast its holdings extensively in the week before trial commences, will take special pains to inform its audience that the court is making no factual findings in this opinion, only deciding whether plaintiffs should be allowed to present all or part of their case to a jury. Parties on all sides of the case have remarked that an extraordinary amount of press coverage seems to have developed out of this lawsuit. This is understandable in a case involving 23,000 plaintiffs and nearly 40 defendants. Defendant Creekmore is a well-known member of the community, having

served as a circuit judge for several counties in this federal division for 20 years. Other of the defendants are professional accountants and lawyers with fine reputations in the community. The court is therefore concerned that persons reading this opinion not "misreport" the court's legal conclusions to the public. The plaintiffs have made a number of allegations against the defendants. This opinion finds that some of them may not be presented to a jury, and that others can be. That is all. The sole aim of this opinion is to determine whether a juror, if he believed the plaintiffs' evidence and the most reasonably favorable interpretation of it, could decide the case adversely to defendants. It goes without saying that no juror is bound to hold against them because of anything we say or do here. The court is very concerned that

the press exercise extreme care in advising the public of the very limited nature of our inquiry, so that no needless prejudice will attend the parties' quest to draw a fair-minded jury from the seven counties in our federal division. We believe that the press has done a good job in this respect, and will continue to do so throughout the remainder of these proceedings. We would feel very uneasy, this close to trial, to release these opinions without appropriate cautions. With this in mind, we will proceed to examine the record on defendants' motions for summary judgment under Rule 56 of the Federal Rules of Civil Procedure.

II. COUNT I: RETURN OF FEES PAID BY THE CO-OP

[Text omitted].

III. COUNT II: FRAUD, NEGLIGENCE, AND CONSPIRACY IN TRANSFER OF GASOHOL PLANT

[Text omitted].

IV. COUNT III: SECURITIES FRAUD IN TRANSFERRING WHITE FLAME STOCK TO THE CO-OP

[Text omitted].

V. COUNT IV: NEGLIGENCE AND FRAUD IN ALLOWING THE CO-OP TO CONTINUE IN OPERATION AFTER INSOLVENCY

[Text omitted].

VI. COUNT VI: ACTIONS UNDER STATE AND FEDERAL SECURITIES LAWS CLAIMS

[Text omitted].

VII. COUNT XII: RICO ACTIONS AGAINST THE LAWYERS AND ACCOUNTANTS

Defendants' legal objections to plaintiffs' RICO causes of action are twofold: first, that plaintiffs cannot prove that the lawyers and accountants participated in the management or control of the Co-Op, Bennett v. Berg, 710 F.2d 1361, 364 (8th Cir. 1983) (en banc); second, that plaintiffs cannot prove that

the lawyers and accountants managed any enterprise "through a pattern" of racketeering activity. Holmberg v. Morrisette, No. 85-5138 (8th Cir., slip op. Sept. 3, 1986); Superior Oil Co. v. Fulmer, 785 F.2d 252 (8th Cir., 1986).

To the extent that plaintiffs base their case against Arthur Young and Co. on allegations that it participated in the operation or management of the Farmers' Co-Op, they must fail. Plaintiffs have compiled an extensive record; yet, from it they are able to show just five acts by Arthur Young which they suggest support a finding of control: (a) the accountants allegedly created the Co-op's financial statements; (b) the accountants failed to obtain client representation letters; (c) they addressed shareholder meetings; (d) they participated in the creation of condensed financial statements; and (e) the

accountants helped the Co-op handle certain matters with government agencies. Perhaps the court misunderstands plaintiffs' theories in this regard, but these activities hardly bespeak the kind of "operation and management" with which we understand Bennett v. Berg, Ibid., to be concerned. Plaintiffs have failed to show anything more than that the accountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceeding the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by Bennett v. Berg, Id.

Conceding that the question of "control" is closer with respect to the

lawyers Ball and Mourton, and Carl Creekmore, we nevertheless find that a RICO case has not been made out against them because plaintiffs have failed to prove that they conducted the affairs of the Co-op through a pattern of racketeering activity. In Sedima v. Imrex, 105 S.Ct. 3275 (1985) the Supreme Court observed in passing that the lower federal courts had failed to develop a meaningful definition of "pattern" in RICO cases, a failing, we submit, for which Congress is primarily liable, having authored the legislation without defining a critical term. That the Sedima court would footnote this issue, one which was not raised by the questions raised in the certiorari petition, nor certified by the court for review, is an indication that the court was troubled by the indiscriminate use of RICO by

plaintiffs victimized by otherwise unremarkable frauds.

We are persuaded by two recent Eight Circuit opinions that plaintiffs have failed to prove that the lawyers participated in the conduct of the Co-op through a pattern of racketeering activity. The earlier opinion of the two held that a single long-running scheme victimizing a single entity does not constitute a RICO pattern. Superior Oil Co. v. Fulmer, supra. The latter opinion held that multiple parties separately victimized by activities relating to a single transaction are confined to their common law remedies since a showing of activity connected with a single transaction negates a finding of a "pattern" of racketeering activity. Holmberg v. Morrisette, supra.

In Superior Oil Co. v. Fulmer, Supra., three individuals siphoned natural

gas from a pipeline for refining and resale, covering up their misdeeds by posting a number of fraudulent meter readings through the mail. There was no evidence that the three committed other acts of the same tenor, or that they had ever attempted to do so. The court of appeals reversed a jury verdict finding the three liable for damages under RICO saying:

"...[P]roof of a 'pattern of racketeering activity' 'requires more than one "racketeering activity" and the threat of continuing activity to be successful. It is this factor of continuity plus relationship which combines to produce a pattern.' ...Superior Oil clearly has proved the 'relationship' prong. They proved several related acts of mail and wire fraud in pursuit of the underlying conversion or theft of gas from Superior Oil's interstate pipeline....

Superior Oil has, however, failed to prove the 'continuity' sufficient to form 'a pattern of racketeering activity'. The actions of Fulmer, Branch and Nichols comprised one continuing scheme to convert gas from Superior Oil's

pipeline. There was no proof that Fulmer, Branch or Nichols had ever done these activities in the past and there is no proof that they were engaged in criminal activities elsewhere.

Superior Oil attempted to show that Fulmer, Branch and Nichols intended to engage in similar gas conversion schemes at other locations. Although it may be that proof of a threat of continuing racketeering activities in the future could, in combination with ongoing acts of racketeering, be sufficient to establish a 'pattern of racketeering,' we find insufficient proof of such a threat here."

The Fulmer court, in short, agreed with Northern Trust Bank/-O'Hare N.A. v. Inryco, Inc., 615 F.Supp. 828, 832 (N.D. Ill. 1985) which said that "[i]t is difficult to see how the threat of continuing activity stressed in the Senate Report could be established by a single criminal episode," noting that "[i]t places a real strain on the language to speak of a single fraudulent effort, involving

several fraudulent acts, as a 'pattern of racketeering activity'."

We view Superior Oil as imposing a "single scheme" limitation on civil RICO cases. Where repetitive criminal activity expresses itself in a single fraudulent effort, the victim will be left to his common law fraud remedies, just as he was in pre-RICO days. We read Superior Oil to hold that the federal interest is ignited only when a party mounts repetitive efforts in distinct episodes.

Whatever doubts we may have entertained about Superior Oil's single scheme limitation were removed by the Eighth Circuit's more recent decision in Holmberg v. Morrisette, supra. The court of appeals decided that the trial court erred in holding the defendant liable under RICO where the plaintiff (one of three parties each of whom was separately

defrauded by the defendant,) was held to have been victimized only in connection with a single scheme, and not otherwise in connection with a pattern of racketeering activity. In Holmberg, three letters of credit, issued by the victims, separately secured the defendant's interest in a business transaction involving an exporter. To avoid a loss, defendant forged invoices and bills of lading to draw down the letters of credit. Even though the Holmberg facts (three separate acts, three different victims) differed from Fulmer's (one continuous siphoning, one victim), the Eighth Circuit declined to characterize this departure as material for purposes of civil RICO. The court said:

"This court thoroughly discussed the parameters of 'pattern' in Superior Oil Co. v. Fulmer... In Superior Oil, we held that several related acts of mail and wire fraud as a part of a single scheme to divert natural gas ... did not amount to a

racketeering activity. There was no evidence suggesting that such activities had occurred previously or that the individuals involved were engaged in other criminal activities....We believe the present case is legally indistinguishable from Superior Oil...

....

We assume for purposes of our review that Holmberg proved that defendants committed acts of wire or mail fraud related to a common purpose or scheme. Our review of the record convinces us, however, that Holmberg has failed, as a matter of law, to prove the continuity necessary to form a 'pattern' of racketeering activity. Defendants' actions comprised one scheme to draw down the three letters of credit securing Mintex's transactions with TransWorld with respect to goods specially produced by Mintex....In one sense defendants' actions were a misguided attempt to obtain payment for goods which they had produced, yet over which they had no control."

In this case, the evidence suggests that the lawyers combined to unload the gasohol plant on the Co-op. There is but one scheme. The plaintiffs' expressed theory of the case, as manifested

in the Consolidated Complaint, charged all the defendants with "a [single] scheme to allow the Co-op to continue in existence, notwithstanding the depletion of its assets by looting". (Complaint ¶158). Somewhat tardily, plaintiffs suggest now that RICO case can be made against the lawyers because they twice victimized the Co-op: once to secure payment of White's legal fees, and once to transfer White's gasohol plant out of his hands.

One need only examine plaintiffs' introduction to its response to Ball and Mourton's motions for summary judgment to find expressed by plaintiffs their own view that the allegedly wrongful acts of the lawyers swung on a single pivot: the December 11, 1980, meeting of the Co-op Board. There Creekmore secured the authority to file both the declaratory judgment action, as well as a resolution

authorizing the Co-op to pay the legal fees of White and Kuykendall. From that one meeting emerged a single victim (the Co-op) allegedly bilked by a single fraudulent device (fiduciaries serving masters with conflicting interests) for the direct benefit of one party (White). Collateral benefits flowed to others, of course, but that fact is unimportant to this analysis.

The allegedly fraudulent activities in this case took place at one time and involved the same people. We do not believe that the Congress's concern that only continuing, repetitively manifested activities be redressed by RICO will be served if we indulge pleading fictions that balkanize essentially unitary transactions. The Eighth Circuit has twice clearly spoken against creative analyses of transactions that "plead defendants into RICO." A common sense view of the record

seems to be clearly called-for. Where a single scheme appears, plaintiffs should be left to their common law remedies, unless the plaintiffs can show that the defendants "did it before and would do it again." In such an event, RICO manifestly has its place, and needs no artful pleading to secure it.

Even if the law allowed plaintiffs to make two schemes out of a single meeting of the Board, we believe that the payment of legal fees by the Co-op is not such a cause of action as necessarily sounds in fraud. Our view of the trustee's suit in Count I is that the gravamen of the action is one for money paid by mistake, sounding in restitution. Indeed, the cases upon which we relied in sustaining the trustee's claim acknowledged that recovery could be obtained without a showing of scienter. Among the theories suggested by the

authorities as substantiating a claim in cases such as this one is "conversion" which, as Prosser notes, "defies definition," having its genesis in the law of trover, requiring only that plaintiff prove his right to possession and the defendant's exercise of dominion over the chattel. Prosser and Keeton, Torts, 5th Ed. 1984, pp. 88-90. We may at leisure criticize the expansion of "conversion" to reach the receipt of money; however, in so doing, we note a recognition by those courts that such a claim is one which, like conversion, does not require a pronounced mental element.

We therefore believe that a pattern of corrupt management of the Co-op has not been proved. We would emphasize that "management" by the lawyers has been assumed rather than found. We do not wish to intimate that attorneys are especially

prone to be found to control RICO enterprises simply by virtue of their calling. We suggest only that the question of "control" in this case is harder to reach than the question of pattern. Our findings, however, do not end our RICO inquiries, since plaintiffs have also charged that the lawyers and accountants operated their own firms as RICO enterprises, through a pattern of racketeering activity.<sup>1</sup>

Defendants E.J. Ball and Ken Mourton obviously participated in the management of the enterprise "Ball and Mourton." The individual Arthur Young accountants obviously participated in the management of Arthur Young. There is no

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<sup>1</sup> [Creekmore was not charged with having operated his own practice in that manner; consequently, the RICO cause of action as to him is dismissed with no additional comment.]

proof in this record that either of these enterprises has been conducted through a pattern of racketeering activity. Rather, what we find is that to the extent that any of these lawyers' or accountants' dealings with the Co-op are wrongful, such dealings are aberrant, and in no way "typical" of the practice of these professionals.

We have mentioned our belief that the Superior Oil case imposed a scheme limitation on RICO. To the extent that an "outsider" directs or influences the affairs of an enterprise, we believe that RICO plaintiffs are obliged to show that he did so through a pattern of abuses. Such a pattern, we believe, cannot be found in events having a nexus to a single transaction. Such a limited showing simply does not permit a reasonable juror to conclude that the "outsider" intends to

pervert the enterprise into an ongoing, continuing engine of fraud.

If the person charged under RICO is an "insider" in his own "enterprise," it is even less likely, as the Sedima court suggested, that two acts or schemes will suffice to prove a pattern. A person acting through the enterprise of another obviously has fewer opportunities to influence its behaviour than he does when acting through his own. This is obviously true in the cases of large law firms and accountancy firms, which will have the opportunity to "manage", loosely speaking, the affairs of hundreds and thousands of clients at a time. In a large and varied practice, a person who twice corrupts a single "outside" enterprise will more likely be found to have managed that particular enterprise through a pattern of wrongful activity, than he would his own.

His "management" of the foreign enterprise may only consist of a limited number of transactions, and his readiness to exploit his association can be measured, quantitatively and qualitatively, against a much smaller range of activity. In such a case, two schemes may suffice.

When managing his own enterprise, wherein thousands of people are concerned and many times that many transactions are implicated, it is correspondingly harder reasonably to find a pattern of corruption arising out of only two discrete and widely separated acts. For example, if a professional service corporation were to send a single inflated bill to a client in 1973, and another to another client in 1982, it could hardly be said that it conducted its affairs through a pattern of racketeering activity. Sedima v. Imrex, supra, acknowledged the unreasonableness

of finding a pattern in such activity, without holding that a pattern can never be found from a showing of two acts or schemes. The court believes that it is possible to find that an individual managed an entity through a pattern of racketeering activity if his "management" were found to consist of a sufficiently limited number of discrete acts, two of which were distinctively and separately fraudulent. Obviously, however, where one acts through his own enterprise literally thousands of times a year, it beggars sense to require him to stand trial under RICO for two overbillings occurring nine years apart.

We believe that RICO claims are most likely to be predicated on "two schemes" when a court is convinced that the schemes are qualitatively and quantitatively significant enough so as to permit a reasonable jury to conclude that

they are somehow "characteristic" of the way a person conducts the affairs of an enterprise. If a person uses his business twice as an engine of fraud against the public in large scale securities offerings, the very distinctiveness of that behaviour may reasonably permit one to conclude that the defendant is determined to use his business as "a racket." By imposing a single scheme limitation on RICO, the courts are only forcing the statute to live up to its name. After all, any kind of fraudulent activity above the level of Three Card Monte will involve more than two acts of mail or wire fraud. An interpretation of RICO which permits every such scheme trebly to be redressed essentially invites every fraud case to be filed in federal court. This would especially be so if, as plaintiffs suggest, RICO frauds need be proved only by a

preponderance of the evidence, whereas common law frauds must be proved clearly and convincingly.

The record is devoid of proof that Ball and Mourton ever operated the affairs of Ball and Mourton so as to defraud any other party, and likewise that any of the individual accountants ever operated Arthur Young so as to defraud another. We therefore conclude that summary judgment must be entered on behalf of Ball, Mourton, Erwin, Cabannis, Drozal and Harrison. They neither controlled or managed the Co-op through a pattern of racketeering activity, nor their own firms. For these reasons as well, we dismiss Arthur Young's RICO crossclaims against the directors. Such claims, if they exist, clearly related to a single transaction or purpose, allegedly to keep the Co-op afloat.

IN THE  
**Supreme Court of the United States**  
OCTOBER TERM, 1991

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BOB REVES, *et al.*,  
v. *Petitioners,*  
ERNST & YOUNG,  
*Respondent.*

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On Petition for a Writ of Certiorari to the  
United States Court of Appeals  
for the Eighth Circuit

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**BRIEF FOR THE RESPONDENT IN OPPOSITION**

---

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### QUESTION PRESENTED

Whether the court below was correct in affirming the district court's grant of summary judgment for respondent on petitioners' claim under the Racketeer Influenced and Corrupt Organizations Act on the ground that respondent, an independent public accounting firm, did not "conduct or participate, directly or indirectly, in the conduct of" the affairs of an alleged RICO enterprise within the meaning of 18 U.S.C. § 1962(c) merely by engaging in two audits of its client's annual financial statements and activities relating thereto.

### **PARTIES TO THE PROCEEDING**

In addition to the parties listed in the caption, in the proceedings below Thomas E. Robertson, Jr., as trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, appeared as a plaintiff/appellee and plaintiff/cross-appellant; and Robert R. Cloar, Class Counsel, was an appellant.

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

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No. 91-886

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BOB REVES, *et al.*,  
v. *Petitioners,*  
ERNST & YOUNG,  
*Respondent.*

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**On Petition for a Writ of Certiorari to the  
United States Court of Appeals  
for the Eighth Circuit**

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**BRIEF FOR THE RESPONDENT IN OPPOSITION**

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**OPINIONS BELOW**

The opinion of the court of appeals is reported at 937 F.2d 1310 and is reproduced in part in Petitioners' Appendix at A-1 to A-49. The pre-trial opinion of the district court granting respondent's motion for summary judgment on petitioners' claim under the Racketeer Influenced and Corrupt Organizations Act is unreported and is reproduced in part in Petitioner's Appendix at A-50 to A-78.

**JURISDICTION**

The judgment of the court of appeals was entered on June 27, 1991 (Pet. App. A-3), and a timely petition for rehearing filed by respondent was denied on August 29, 1991. The petition for a writ of certiorari was filed

on November 27, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

### STATEMENT

1. This case arises out of the 1984 bankruptcy of the Farmer's Cooperative of Arkansas and Oklahoma, Inc. ("Co-op").<sup>1</sup> The Co-op was organized in 1946 and was conducting extensive business operations in western Arkansas and eastern Oklahoma by the late 1970's. Each year, the Co-op's membership elected twelve members to serve on the Co-op's board of directors. The board met monthly to review the Co-op's operations and delegated day-to-day management of the Co-op's business to a general manager, whom the board appointed. Jack White served as the Co-op's general manager from 1952 through mid-1982, when the board removed him. Pet. App. A-6.

Beginning in 1959, the Co-op raised capital to support its general business operations by selling promissory notes payable on demand of the holder. These demand notes were uncollateralized and uninsured, but were attractive to investors because they paid a higher rate of interest than the rates offered by local financial institutions. Pet. App. A-6 to A-7.

Arthur Young & Company was first retained as the Co-op's independent auditor in 1981.<sup>2</sup> In that capacity it subsequently issued audit reports on the Co-op's financial statements for the years ending December 31, 1981 and

<sup>1</sup> The facts set forth here are those most relevant to the decision of the court below on petitioners' RICO claim. A more detailed statement of the facts underlying the entire case is set forth at pages 1-10 of respondent's petition for a writ of certiorari, which was filed on November 27, 1991. *Ernst & Young v. Reves*, No. 91-877.

<sup>2</sup> In 1989, Arthur Young and Ernst & Whinney combined to form the firm of Ernst & Young, which is the respondent in this case. Because the events at issue occurred prior to 1989, we will refer to respondent as Arthur Young.

December 31, 1982. In addition, representatives of Arthur Young gave oral presentations on the financial condition of the Co-op at its annual meetings in May 1982 and March 1983. At these meetings, condensed financial statements prepared by the Co-op were distributed to the audience.<sup>3</sup> At the 1982 annual meeting, the presentation of Arthur Young's representative lasted approximately five minutes during which he described the condensed financial statements and answered questions from the audience. *Id.* at A-25 to A-26. The oral presentation of Arthur Young's representative at the 1983 meeting lasted approximately three minutes. *Id.* at A-33.

On February 23, 1984, the Co-op filed for bankruptcy. Pet. App. A-35. Less than a year later, the Co-op's bankruptcy trustee filed an action in the United States District Court for the Western District of Arkansas on behalf of the Co-op and certain demand note holders against forty individuals and entities including Jack White, members of the Co-op's board, several of the Co-op's lawyers, Arthur Young and the two auditors that preceded Arthur Young. The complaint alleged a wide variety of federal and state causes of action, including common law fraud, violations of the registration and disclosure provisions of the Arkansas Securities Act, violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j, and violations of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961-68. The essence of the claims against Arthur Young was that it had misvalued the Co-op's assets and thereby allowed the Co-op's financial statements to be misstated. Subsequently, the district

<sup>3</sup> Although they were based on financial statements audited by Arthur Young, the condensed financial statements that were distributed at the 1982 annual meeting were prepared by the Co-op and not Arthur Young. Pet. App. A-24 n.10. Arthur Young's representative at that meeting received the condensed financial statements upon arriving at the meeting. *Id.* at A-25. The condensed financial statements distributed at the 1983 annual meeting also were prepared by the Co-op. *Id.* at A-32.

court certified a class of persons who purchased demand notes between February 15, 1980 and February 23, 1984, and named Bob Reves, Francis Graham, and Robert Gibbs as the class representatives. *Id.* at A-36 to A-37.

Petitioners alleged in their complaint that Arthur Young had conducted or participated in the conduct of the affairs of the Co-op through a pattern of racketeering activity consisting of mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c). Pet. App. A-44 to A-45. After the close of extensive discovery, Arthur Young moved for summary judgment on this claim, urging two grounds: first, that petitioners could not establish that Arthur Young had conducted or participated in the conduct of the Co-op's affairs within the meaning of Section 1962(c); and, second, that petitioners could not demonstrate that Arthur Young had engaged in a pattern of racketeering as required by the statute. *Id.* at A-58 to A-59. The district court granted Arthur Young's motion on the former ground, holding that under the Eighth Circuit's decision in *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008 (1983), mere participation in auditing activities is insufficient to constitute participation in the affairs of a RICO enterprise under Section 1962(c). The district court stated:

Plaintiffs have failed to show anything more than that the accountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceeding (*sic*) the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by *Bennett v. Berg*, *Id.*

Pet. App. A-60.<sup>4</sup>

<sup>4</sup> Petitioners also argued to the district court that the Arthur Young auditors had operated *Arthur Young* through a pattern of racketeering activity. Pet. App. A-72. Under this theory Arthur

In addition to granting Arthur Young's motion for summary judgment on the RICO claim, the district court ruled on various other issues on which Arthur Young had sought summary judgment. The court granted Arthur Young's summary judgment motion on all of petitioners' claims against it other than the Section 10(b) claims and claims that Arthur Young was secondarily liable for disclosure violations of the Arkansas Securities Act. After trial, the jury found that Arthur Young had committed primary violations of Section 10(b) and secondary violations of the Arkansas securities statute. *Id.* at A-40.<sup>5</sup> The jury awarded damages of \$6.1 million to members of the Class who purchased demand notes between April 22, 1982, the date Arthur Young submitted its first audit report to the Co-op's board, and February 23, 1984, the date the Co-op filed for bankruptcy. *Id.* at A-41, Petitioner's Appendix, Vol. I at p. 56a in *Ernst & Young v. Reves*, No. 91-877.

Both Arthur Young and petitioners appealed the district court's judgment to the United States Court of Appeals for the Eighth Circuit. In its first opinion in this case, the court of appeals held that the demand notes were not securities under federal and Arkansas securities laws and reversed the district court's judgment. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). This Court granted certiorari and reversed the judgment of the Eighth Circuit, holding that the demand notes were se-

Young, rather than the Co-op, was the alleged RICO enterprise. The court rejected that contention, noting that while the individual Arthur Young auditors had obviously participated in the management of Arthur Young, there was no proof that Arthur Young had been conducted through a pattern of racketeering activity. The court noted that to the extent Arthur Young's dealings with the Co-op were wrongful, "such dealings are aberrant, and in no way 'typical' of the practice of these professionals." *Id.* at A-73.

<sup>5</sup> Prior to trial, all defendants except Arthur Young and White's lawyers settled the claims against them. Pet. App. A-37. White's lawyers settled after trial. *Id.* at A-37 n.14.

curities under federal securities law. *Reves v. Ernst & Young*, 110 S.Ct. 945 (1990).

On remand, the court of appeals concluded that the demand notes were securities under Arkansas law and affirmed the district court's judgment that Arthur Young had committed primary violations of Section 10(b) and was secondarily liable for violations of the Arkansas Securities Act. The court of appeals also affirmed the district court's grant of summary judgment to Arthur Young on petitioners' RICO claim. Viewing the evidence in the light most favorable to petitioners, Pet. App. A-45, the court held that Arthur Young's involvement with the Co-op did not rise to the level necessary to conclude that Arthur Young had participated in the conduct of the Co-op's affairs under Section 1962(c). On that issue, the court applied its prior ruling in *Bennett*, in which it had stated that "[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." *Id.* at A-46 (quoting *Bennett*, 710 F.2d at 1364). Recognizing that "Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings," Pet. App. A-46, the court concluded that that activity fell short of what *Bennett* requires.

## ARGUMENT

Petitioners contend (Pet. 1) that there is a "well-developed conflict" among the circuits on the "level of participation" in the conduct of the affairs of a RICO enterprise that is required to subject a defendant to liability under 18 U.S.C. 1962(c). Specifically, petitioners assert (Pet. 9-15) that in *United States v. Scotto*, 641 F.2d 47 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981), and *United States v. Cauble*, 706 F.2d 1322 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984), the courts established liability standards that conflict directly with the standard set forth in *Bennett* that was applied by the court below. Petitioners further argue that had their RICO claim been evaluated under any standard other than *Bennett*, the district court would have been required to submit that claim to the jury (Pet. 10-14).

For the reasons set forth below, this claimed conflict is more apparent than real and does not warrant review by this Court. The courts of appeals have indeed fashioned a number of different tests in a wide variety of circumstances to resolve the often complex and multifaceted question of whether a defendant has "conduct[ed] or participate[d], directly or indirectly, in the conduct of [an] enterprise's affairs through a pattern of racketeering activity" within the meaning of 18 U.S.C. § 1962(c). But that does not mean that there is a "direct" and "well-developed" (Pet. 1, 9) conflict on the narrow issue presented in this case—*i.e.*, whether an independent public accounting firm can be held to have conducted or participated in the conduct of an enterprise's affairs under Section 1962(c) by auditing its client's financial statements. On that issue, courts applying the supposedly most "liberal" standard—the *Scotto* test—have joined the court below in concluding that such conduct, standing alone, is insufficient to constitute a basis for RICO liability. These and other decisions demonstrate that there is no inherent conflict between *Bennett* on the one hand and *Scotto* and *Cauble* on the other, and that the latter

cases have not repudiated the Eighth Circuit's requirement of "some participation in the operation or management of the enterprise itself" as a prerequisite for liability. *Bennett*, 710 F.2d at 1364. Indeed, in all of the cases on which petitioners rely, with the possible exception of the Eleventh Circuit's decision in *Bank of America v. Touche Ross & Co.*, 782 F.2d 966 (11th Cir. 1986), the *Bennett* standard has been met. Thus, if there is any conflict on the question presented here, it arises not from the decision below but from a six-year-old decision in another circuit that applied a standard that deviates not only from *Bennett* but from *Scotto* and *Cauble* as well. Given the lack of substantial conflict on the specific issue raised by the petition, which was resolved correctly by the court below, the petition should be denied.

1. Petitioners err in asserting that *Scotto*, *Cauble* and cases from other circuits that have followed those decisions are fundamentally incompatible with *Bennett*. None of these cases concerns accountant liability under Section 1962(c); none of them rejects the *Bennett* standard, and in each of them *Bennett*'s requirement of "some participation in the operation or management of the enterprise itself" (710 F.2d at 1364) was demonstrated. Moreover, the focus of these authorities is not on the "level of participation" (Pet. 9) required for RICO liability; instead these cases turn on whether *given* a defendant's substantial and ongoing participation in the conduct of an enterprise, a sufficient nexus has been established between the defendant, *his racketeering activity* and the enterprise to conclude that the defendant has conducted the enterprise *through* a pattern of racketeering activity as Section 1962(c) requires. Accordingly, the authorities on which petitioners rely to demonstrate a circuit split are largely irrelevant to the issue presented by the decision below.

a. In *Scotto*, the defendant was charged and convicted, *inter alia*, of violating Section 1962(c) by participating

in the conduct of a labor union's affairs through a pattern of racketeering activity that consisted of accepting more than forty illegal labor payments over a five-year period from six separate businesses that employed union members. 641 F.2d at 50-51. As president of the union local and a vice-president of the national union, *id.* at 51, Scotto unquestionably participated in the "operation" or "management" of the union's affairs. On appeal, he did not contest that fact but rather challenged the district court's charge to the jury as failing to require a sufficient nexus between the pattern of racketeering activity (his acceptance of the illegal payments) and his conduct of the affairs of the union. The Second Circuit upheld the adequacy of the district court's charge and in that context framed the legal standard that petitioners assert is incompatible with *Bennett*: "one conducts the activities of the enterprise through a pattern of racketeering when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise." 641 F.2d at 54. Finding a sufficient connection between the defendant's acceptance of illegal labor payments and his conduct of union affairs as a union officer, the court affirmed the conviction. Nowhere in its opinion, however, did the court address the specific issue that confronted the panel below and was before the Eighth Circuit in *Bennett*—whether the defendant's conduct in relation to the enterprise was of such magnitude that one could conclude that the defendant had conducted or participated in the conduct of the enterprise's affairs under Section 1962(c).<sup>6</sup>

<sup>6</sup> *United States v. Provenzano*, 688 F.2d 194 (3d Cir.), *cert. denied*, 459 U.S. 1071 (1982), and *United States v. Yarbrough*, 852 F.2d 1522 (9th Cir.), *cert. denied*, 488 U.S. 866 (1988), which petitioners cite as adopting the *Scotto* rule (Pet. 12 n.6), are similarly distinguishable. In *Provenzano*, the defendant, who was the business agent, secretary-treasurer and then president of a union local, was convicted under Section 1962(c) for accepting illegal payments from

b. *Cauble* and the decisions following it (Pet. 13-14) are likewise unavailing to petitioners. As in *Scotto*, the court in *Cauble* focused on the nexus required by Section 1962(c) between the racketeering activity and the RICO enterprise. 706 F.2d at 1332. The defendant contended on appeal that the racketeering activity at issue, aiding and abetting the smuggling of marijuana and related violations of the Travel Act, was conducted by an enterprise other than that charged in the indictment, and that there therefore was a failure of proof on (i) the existence of the alleged RICO enterprise, *Cauble Enterprises*, and (ii) the required nexus between defendant's racketeering activity and that enterprise. *Id.* at 1340-41. Defendant also challenged the sufficiency of the evidence on his commission of the racketeering acts. *Id.* at 1339-40. In that

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four separate companies in exchange for labor peace. 688 F.2d at 196. On appeal Provenzano argued that the government had failed to prove the requisite nexus between the union local and his racketeering activity since there was no showing that the union was advanced or benefited by such activity. *Id.* at 199. The court rejected this challenge, citing *Scotto* and ruling that "by accepting bribes in exchange for allowing violations of the collective bargaining agreements to be overlooked, Provenzano was conducting his union office through racketeering activity. The fact that the union was harmed rather than benefited does not remove the conduct from RICO's ambit." *Id.* at 200. There was no issue in *Provenzano* of whether the defendant conducted the enterprise's affairs, nor could there have been, given Provenzano's position as a union officer. In *Yarbrough* the defendant conceded both his membership in the RICO enterprise, a radical right-wing, white-supremacist group engaged in violent criminal activity, and his participation in a pattern of racketeering activity. 852 F.2d at 1544. He argued on appeal that the government had failed to prove that the racketeering activity was the means through which he participated in the enterprise. *Id.* The court acknowledged that Section 1962(c) requires a nexus between the racketeering activity and the enterprise, and in affirming the conviction cited *Scotto* as establishing the test for determining whether that nexus exists. 852 F.2d at 1544. The court did not need to consider, however, much less resolve, the issue whether the defendant participated in the conduct of the enterprise's affairs, given his conceded membership in the group.

context the court formulated and applied its "participation" test, requiring proof that: (1) the defendant committed the racketeering acts as alleged, (2) the defendant's position in the enterprise facilitated his commission of those acts, and (3) the predicate acts had some effect on the enterprise. *Id.* at 1332-1333, 1339-1341. The court sustained the jury's findings that the defendant committed the predicate acts, that *Cauble Enterprises* was the RICO enterprise, and that it was through that enterprise that the defendant engaged in the racketeering activity. *Id.* at 1339-1341. However, the court did not address whether the defendant's "level of participation" (Pet. 9) in the enterprise was sufficient to conclude that the defendant had conducted or participated in the conduct of the enterprise's affairs. On that issue there was no doubt that the *Bennett* standard was met, for the defendant was a general partner in *Cauble Enterprises* and had extensive, and to a degree exclusive, control over the partnership assets used in the illegal smuggling operations. 706 F.2d at 1331, 1339-1341.<sup>7</sup>

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<sup>7</sup> The cases cited by petitioners as following *Cauble*, *United States v. Qaoud*, 777 F.2d 1105, 1115 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986), and *United States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988), are to the same effect. In *Qaoud*, the court cited *Cauble* for the proposition that there must be a nexus between the RICO enterprise and the pattern of racketeering activity for liability to attach under Section 1962(c). 777 F.2d at 1115. The defendants did not challenge their convictions on the "participation" issue but rather contested the government's alleged failure to prove the existence of a RICO enterprise and its effect on interstate commerce. *Id.* at 1114-1117. In *Pieper*, the defendant, who was the chief executive of a union local and its health and pension fund, challenged the sufficiency of the evidence on his commission of racketeering acts and the nexus between his racketeering activity and the enterprise. 854 F.2d at 1026-1027. As in *Scotto* and *Provenzano*, *see n.6 supra*, there was no contention in *Pieper* that the defendant did not conduct or participate in the conduct of the enterprise's affairs, nor could there have been a serious question on that score given the defendant's union positions.

Thus, *Scotto*, *Cauble*, and the decisions following them had as the *starting* point of their analysis what the Eighth Circuit in *Bennett* declared to be a prerequisite to liability under Section 1962(c)—“some participation in the operation or management of the enterprise itself.” 710 F.2d at 1364. And from there the courts determined, utilizing the *Scotto* and *Cauble* tests, whether there was a sufficient relationship between the defendant’s racketeering activity and the enterprise to conclude that the defendant participated in the conduct of such affairs *through* the pattern of racketeering activity. In making that very determination, the Eighth Circuit itself has employed the *Cauble* test. See *United States v. Ellison*, 793 F.2d 942, 950 (8th Cir.), *cert. denied*, 479 U.S. 937 (1986) (affirming defendant’s conviction under Section 1962(c) and finding the requisite nexus between the racketeering activity and the RICO enterprise of which the defendant was the leader and founder). But the *Scotto* and *Cauble* standards were neither formulated nor utilized to resolve the closely related but nonetheless analytically distinct question that was before the court below (and is framed in this petition at 9)—what “level of participation” is necessary to conclude that a defendant has conducted or participated in the conduct of an enterprise’s affairs under Section 1962(c). For this reason, *Scotto* and *Cauble* may complement *Bennett*, but they do not fundamentally conflict with it.

2. Even though there is no inherent conflict between *Scotto*, *Cauble* and *Bennett*, many courts, including the court below (Pet. App. A-47), view these cases as establishing disparate and competing standards. See, e.g., *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 952-55 (D.C. Cir. 1990) (*en banc*), *cert. denied*, 111 S.Ct. 2839 (1991). In general, however, there is little indication that varying standards have led to conflicting results under Section 1962(c). Courts that have utilized more than one standard in a case typically have arrived at the same conclusion under

each. See, e.g., *Official Publications, Inc. v. Kable News Co.*, 775 F. Supp. 631, 635 and n.1 (S.D.N.Y. 1991) (denying motion to dismiss and finding the requisite participation under both *Bennett* and *Scotto* where the defendants were the principal officers of the enterprise); *Vista v. Columbia Picture Industries, Inc.*, 725 F. Supp. 1286, 1296 (S.D.N.Y. 1989) (denying motion to dismiss and finding the requisite participation under both *Bennett* and *Scotto* where the defendant engaged in the day-to-day affairs of the business); *United States v. Kaye*, 586 F. Supp. 1395 (N.D. Ill. 1984) (finding participation insufficient under both *Bennett* and *Cauble* where the defendant’s conduct had no direct effect on the enterprise’s functions). Similarly, different courts applying different standards have reached the same result on essentially the same set of facts. See *Overnite Transportation Co. v. Truck Drivers, Oil Drivers Union Local No. 705*, 904 F.2d 391 (7th Cir. 1990) (holding under *Cauble* that a pattern of strike-related violence does not constitute union participation in the conduct of the employer’s affairs); *Yellow Bus Lines*, *supra* (holding to the same effect under a standard equivalent if not identical to the *Bennett* test).

More importantly, on the narrow issue presented here—the liability of an independent public accounting firm for auditing acts under RICO—courts applying the supposedly most “liberal” standard, the *Scotto* rule, have reached exactly the same conclusion as that reached by the court below: *i.e.*, that such conduct, standing alone, is insufficient under Section 1962(c). As the district court noted in *Plains/Anadarko-P Ltd. Partnership v. Coopers & Lybrand*, 658 F. Supp. 238, 240 (S.D.N.Y. 1987):

The federal statutory requirement that an enterprise be *conducted* by the accused accountants is not satisfied when a professional accountant enters an engagement of finite duration and scope, undertaken for a particular client; nor does such a set-up express

the essential "continuity" element of a racketeering enterprise embraced by the statute. The auditing and reporting acts of the accountants, without more, would not establish a connection to the enterprise or the pattern requirements of the statutes; they would be auditing acts, not enterprise activities nor connected or interrelated activities.

For that reason, the district court, applying the *Scotto* test, granted the defendant's motion to dismiss. 658 F. Supp. at 240. Other district courts within the Second Circuit have reached the same result. See *Goldman v. McMahan, Brafman, Morgan & Co.*, 706 F. Supp. 256, 261-62 (S.D.N.Y. 1989) (applying *Scotto* and dismissing the RICO claim against an accounting firm based on alleged false financial statements and allegations that the firm stood to profit from future fees if the alleged scheme to force plaintiffs to relinquish their partnership interest succeeded); *Morin v. Trupin*, 747 F. Supp. 1051, 1066 (S.D.N.Y. 1990) (requiring, in repleading of RICO allegations against accountants and other professionals, a factual basis for a relationship between those professionals and the enterprise "different than the typical contractual relationship between client and professional"); *Griffin v. McNiff*, 744 F. Supp. 1237, 1255 n.18 (S.D.N.Y. 1990) (citing *Plains/Anadarko-P* and *Goldman, supra*).

Accordingly, petitioners err in their primary contention (Pet. 10-14)—that had their RICO claim been evaluated under any standard but *Bennett*, it would have been submitted to the jury. In the Second Circuit, under *Scotto*, the result would have been the same.

3. The Eleventh Circuit's decision in *Bank of America*, the only apparently conflicting decision cited by petitioners, should not prompt this Court's review in this case. While the court in *Bank of America* rejected *Bennett*'s requirement of some participation by the defendant in the operation or management of the enterprise, 782 F.2d at 970, and further held that a mere allegation

that accountants had prepared and disseminated false financial statements was sufficient to withstand a motion to dismiss, *id.*, it is not entirely clear from the opinion whether independent public accountants could be held liable for auditing activities under Section 1962(c). In that connection, the court noted the defendants' argument that, as independent accountants, they did not participate in the conduct of the affairs of the enterprise, but concluded that that argument raised a question of fact that could not be addressed on a motion to dismiss. *Id.* In this case, in contrast, the decision of the district court was rendered on a fully developed summary judgment record.<sup>8</sup> It is possible, therefore, that in the Eleventh Circuit, as in the court below, an independent accountant could demonstrate on a motion for summary judgment the limited nature of his engagement and, if that were established, would prevail. Thus, while the decision in *Bank of America* rejects *Bennett* on its face, it does not necessarily support the proposition that petitioners urge—i.e., that an independent accounting firm can be held liable under Section 1962(c) for mere auditing acts.

But even if *Bank of America* stands for what petitioners claim, that does not mean that the issue presented in this case requires resolution by this Court. Since the Eleventh Circuit issued its decision, several district court decisions in the Southern District of New York and now the Eighth Circuit have held to the contrary. The Eleventh Circuit's six-year-old decision is the oldest court of appeals decision on this issue and occupies a distinct minority position. This is not a situation in which a recently decided case is in conflict with an established trend; to the contrary, the trend is clearly in the direction of the

<sup>8</sup> The district court had earlier denied respondent's motion to dismiss, holding that the allegations of the complaint were sufficient to withstand scrutiny under *Bennett*. See Petitioner's Appendix, Vol. I at pp. 117a-118a in *Ernst & Young v. Reves*, No. 91-877. It was only on a fully developed summary judgment record that respondent prevailed.

decision below. The need for this Court's review is, therefore, substantially diminished.

4. The petition should also be denied because the decision below is correct and the standard it adopts faithful to both the language and purpose of the statute. In 18 U.S.C. § 1962(c), Congress made it illegal to "conduct or participate, directly or indirectly, in the *conduct* of [an] enterprise's affairs through a pattern of racketeering activity" (emphasis added). Congress stopped short of proscribing mere participation in an enterprise's affairs through racketeering activity. Accordingly, for a defendant to violate that statute, he must not merely have participated in the enterprise's affairs, but in the *conduct* of the enterprise's affairs. By requiring ordinarily "some participation in the operation or management of the enterprise itself," 710 F.2d at 1364, *Bennett* is consistent with this statutory language and Congress's focus on "conduct." See *Yellow Bus Lines*, 913 F.2d at 953-54; *United States v. Kaye*, 586 F. Supp. at 1400. The court in *Bank of America*, in contrast, read the "conduct" element of Section 1962(c) out of the statute entirely, holding that, "[t]he word 'conduct' in § 1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise." 782 F.2d at 970 (citing *United States v. Martino*, 648 F.2d 367 (5th Cir. 1981), *aff'd on other grounds sub nom. Russello v. United States*, 464 U.S. 16 (1983)). But if that were the case, then anyone dealing with any enterprise in a business capacity would be in peril of RICO liability since virtually every commercial transaction entails the provision of a good or service that is "necessary" or "helpful" to the business's operations. If Congress had wanted to proscribe mere *participation* in an enterprise's affairs through racketeering activity, it could have done so. In Section 1962(c), it plainly did not.

Further, while we are mindful of this Court's admonition against restrictive interpretations of RICO that

might frustrate Congress's purposes, *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 236-237 (1989) (citing *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499-500 (1985)), *Bennett* is fully consistent with those purposes—"the elimination of the infiltration of organized crime and racketeering into legitimate organizations operating in interstate commerce." S. Rep. No. 617, 91st Cong., 1st Sess. 76 (1969). See also *Russello v. United States*, 464 U.S. 16, 20 (1983); *United States v. Turkette*, 452 U.S. 576, 589 (1981). In Section 1962(c), Congress sought not to outlaw every predicate act committed in a business setting, but rather to forbid such acts when they become the vehicle through which a defendant conducts or participates in the conduct of an enterprise's affairs. The statute was enacted to curtail "the use of force, threat of force, enforcement of illegal debts, and corruption in the acquisition or operation of business." S. Rep. No. 617, *supra*, at 81. By requiring participation in the operation or management of the alleged RICO enterprise, the court below was in accord with that congressional mandate. On the other hand, the standard set forth in *Bank of America* is capable of transforming every business tort into a RICO violation irrespective of the congressional purpose.

Finally, petitioners err in contending that *Bennett* virtually precludes Section 1962(c)'s applicability to corporate outsiders (Pet. 15-16, 23-24) and is inconsistent with this Court's decision in *Northwestern Bell Tel.* (Pet. 22-23). There is nothing in *Bennett* that requires a defendant to be an "insider" as a precondition to liability; it is only necessary that the defendant—whether insider or outsider—participate in the operation or management of the enterprise. And as the court noted in *Yellow Bus Lines*, the "operation" and "management" standard is fully applicable to outsiders: it "can as easily be applied to—for example—an organized crime boss who pulls the strings of a corporation through a puppet president as it can be to the corporation president himself." 913 F.2d

at 953. Furthermore, there is nothing in *Bennett* precluding liability for outsiders when they collectively constitute the enterprise through which the pattern of racketeering activity occurs. See, e.g., *Department of Economic Dev. v. Arthur Andersen & Co.*, 683 F. Supp. 1463, 1481-82 (S.D.N.Y. 1988) (holding that plaintiff stated a claim in alleging that the defendant accounting firms themselves, or with another entity, constituted an enterprise through which the accountants were engaging in racketeering activity by issuing false financial statements). In this case petitioners made that very allegation, which the district court determined could not be sustained on the record. See n.4 *supra*. Lastly, this Court's decision in *Northwestern Bell Tel.* does not cast a cloud over *Bennett* since the "participation" issue was not before this Court in that case; instead, the case concerned the pattern requirement under Section 1962(c).

### CONCLUSION

The petition for a writ of certiorari should be denied.  
Respectfully submitted.

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JANUARY 1992

(5)

No. 91-886

Supreme Court, U.S.  
FILED

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In The  
**Supreme Court of the United States**  
October Term, 1991

BOB REVES, ROBERT H. GIBBS,  
and FRANCES GRAHAM,  
As Representatives Of A Class Of Note Holders,  
*Petitioners,*

v.

ERNST & YOUNG,

*Respondent.*

On Writ Of Certiorari To The United States  
Court Of Appeals For The Eighth Circuit

JOINT APPENDIX  
VOLUME I  
(Through page 225)

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Petition For Certiorari Filed November 27, 1991  
Certiorari Granted February 24, 1992

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IN THE UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF ARKANSAS  
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., *et al.*, Plaintiffs,

v.

JACK E. WHITE, *et al.*, Defendants.

Consolidated Cases No.  
85-2044, 85-2096, 85-2155, 85-2259

RELEVANT DOCKET ENTRIES

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
2/14/85	Plaintiffs	COMPLAINT.
3/19/85	Plaintiffs	First Amended COMPLAINT.
9/13/85	Plaintiffs	Consolidated COMPLAINT.
8/14/86	Arthur Young	MOTION of the Arthur Young Defendants for SUMMARY JUDGMENT; Statement of Undisputed Material Facts; MEMORANDUM of the Arthur Young Defendants In Support of Their Summary Judgment Motion.
9/5/86	Plaintiffs	Plaintiffs' RESPONDING MEMORANDUM to the Motion of the Arthur Young Defendants for Summary Judgment.

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
9/11/86	Defendant	REPLY MEMORANDUM of the Arthur Young Defendants in Support of Their Summary Judgment Motion.
10/15/86	Court	MEMORANDUM OPINION Granting in Part Arthur Young's Motion for Summary Judgment.
10/16/86	Court	ORDER.
2/5/87	Court	JUDGMENT ORDER After Jury Verdict.
4/27/87	Court	AMENDED JUDGMENT ORDER After Jury Verdict.
10/14/87	Court	JUDGMENT Regarding Interest Rate To Be Applied To Amended Judgment Order.

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UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT  
87-1726 WA, 87-1727 WA, 87-1803 WA  
Consolidated

---

THOMAS E. ROBERTSON, JR., *et al.*, and  
BOB REVES, *et al.*,  
Plaintiffs, Cross-Appellants, and Appellees,

v.

ARTHUR YOUNG & COMPANY,  
Defendant, Appellant, and Cross-Appellee,

v.

HAL BREWER, *et al.*,  
Third-Party Defendants and Appellees.

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#### RELEVANT DOCKET ENTRIES

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
9/15/87	Arthur Young	Appellant's BRIEF
10/16/87	Reves, et al. and Robertson	Appellees and Cross-Appellants' BRIEF
11/13/87	Arthur Young	REPLY BRIEF

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
12/11/87	Reves, et al. and Robertson	REPLY BRIEF
9/2/88	Court	OPINION and ORDER Reversing Denial Of Arthur Young's Motion For Judgment J.N.O.V. And Denying The Class' And Trustee's Cross- Appeals.

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No. 88-1480

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IN THE  
SUPREME COURT OF THE UNITED STATES  
OCTOBER TERM, 1988

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BOB REVES, ROBERT H. GIBBS, and  
FRANCES GRAHAM,  
As Representatives of a Class of Note Holders,  
  
*Petitioners,*  
  
v.  
ERNST & YOUNG,  
  
*Respondent.*

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RELEVANT DOCKET ENTRIES

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
6/12/89	Court	Letters reflecting ORDER that Petition for Certiorari is Granted.
2/21/90	Court	OPINION and ORDER. Court of Appeals decision is REVERSED and REMANDED.

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UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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Nos. 87-1726WA, 87-1727WA, 87-1803WA,  
87-2533WA, 88-1014WA

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THOMAS E. ROBERTSON, JR., and BOB REVES, *et al.,*  
  
Plaintiffs, Cross-Appellants, and Appellees,  
  
v.  
ERNST & YOUNG,  
  
Defendant, Appellant, and Cross-Appellee.

---

RELEVANT DOCKET ENTRIES

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
7/10/90	Ernst & Young	SUPPLEMENTAL BRIEF on Remand of Appellant.
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9/6/90	Ernst & Young	SUPPLEMENTAL REPLY BRIEF on Remand.
9/25/90	Reves, et al. and Robertson	SUPPLEMENTAL REPLY BRIEF on Remand.

<u>Date</u>	<u>Filed By</u>	<u>Description</u>
6/27/91	Court	OPINION Affirming In Part and Reversing In Part.
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IN THE UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF ARKANSAS  
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the  
Farmer's Co-op of Arkansas & Oklahoma,  
Inc.; BOB REVES; FRANCES GRAHAM, ROBERT H.  
GIBBS, individually; ROBERT H. GIBBS, as  
natural guardian of his minor children,  
THOMAS A. GIBBS and ROBERT H. GIBBS, JR.;  
and ROBERT H. GIBBS, as Trustee of the  
Muskogee Internal Medicine Group Profit  
Sharing Funds,

Plaintiffs,

v.

JACK E. WHITE, ET AL.,

Defendants.

Consolidated Cases No. 85-2044,  
85-2096, 85-2155, 85-2259  
H. Franklin Waters, Chief Judge

**MEMORANDUM OPINION**  
**FILED OCTOBER 15, 1986**

I. INTRODUCTION

In Robertson v. White, 633 F.Supp.  
954 (W.D. Ark. 1986) we tested the legal  
sufficiency of the plaintiffs' consolidated  
complaint. We tried to make it clear at

that time that our purpose was to determine which allegations could sustain a cause of action under the most liberal and indulgent construction. Even so, the court was greatly troubled by certain of the plaintiff's claims. We suggested that some of them may very well have been barred by the statutes of limitations. Instead of dismissing them at that point, we advised the parties that we would rule on the questions later, in connection with motions for summary judgment. In addition, we expressed reservations about the applicability of certain causes of action to the parties. In this connection, we were doubtful that R.I.C.O. questions could be raised against the work of auditors, based on dicta in Bennett v. Berg 710 F.2d 1361 (8th Cir. 1983). The passage of time has brought with it two recent Eighth Circuit civil R.I.C.O. decisions which

raised for our consideration vexing questions whether any of the defendants had been shown to have operated an enterprise "through a pattern" of racketeering activity. See, Fulmer v. Superior Oil Co., 785 F.2d 252 (8th Cir. 1986) and Holmberg v. Morrisette, Civ. 85-5138 (8th Cir., slip op., Sept. 3, 1986). That the court of appeals for our circuit would overturn two verdicts, the factual findings of which are to be deemed controlling unless "clearly erroneous" FRCP, Rule 52(b), indicates to us that the court to whom we are immediately responsible has developed and is developing a requirement for pattern fundamentally more rigorous than one which it suggested might be appropriate in Alexander Grant v. Tiffany Industries, 770 F.2d 717, 718 n.1 (8th Cir., 1985). Those who thirst for consistency in the law can find their solace in the fact that

Alexander Grant explicitly said that it was not passing on the sufficiency of a showing of pattern in its decision, was judging (as we did) only the sufficiency of a pleading, and, coming a year before Fulmer and Holmberg, can hardly be said to be the final word on the topic. It may be possible that our system of notice pleading will permit still more R.I.C.O. cases to enter discovery, since "pattern", unlike fraud, may not have to be specifically pleaded. It is probable, therefore, that cases under a Rule 12 examination will continue to confuse the resolution of motions arising under Rule 56. The sufficiency of the plaintiffs' case is here today subjected to a more rigorous screening than the one which we pursued a half a year ago. In that connection, too, the rules for decision have changed. Whereas formerly the Eighth Circuit

enjoined that motions under Rule 56 be denied if even the "slightest doubt" was present, Traylor v. Black, Sivalis, and Bryson, 189 F.2d 213 (8th Cir., 1951); now the trial courts are admonished to enter judgment against parties where no reasonable jury could find for them on the best construction of facts submitted in support of their case. Anderson v. Liberty Lobby, Inc., 54 U.S.L.W. 4755 (June 23, 1986). We do not sit as triers of fact, and make no credibility determinations, since under our Constitution, that lies with the province of the jury. U.S. Const., Amendment 7. Rather, we determine whether, for example, the plaintiffs' evidence, if believed, suffices, to present a factual question subject to resolution by a jury. If not, we enter judgment for the moving party, as we did for plaintiffs on their securities law claims a few months

earlier. Robertson v. White, 635 F. Supp. 851 (W.D. Ark. 1986).

If it appears to the professional reader that the court is writing far too pedantically, we plead guilty and offer by way of explanation our hope that members of the press, who will read this opinion and broadcast its holdings extensively in the week before trial commences, will take special pains to inform its audience that the court is making no factual findings in this opinion, only deciding whether plaintiffs should be allowed to present all or part of their case to a jury. Parties on all sides of the case have remarked that an extraordinary amount of press coverage seems to have developed out of this lawsuit. This is understandable in a case involving 23,000 plaintiffs and nearly 40 defendants. Defendant Creekmore is a well-known member of the community, having

served as a circuit judge for several counties in this federal division for 20 years. Other of the defendants are professional accountants and lawyers with fine reputations in the community. The court is therefore concerned that persons reading this opinion not "misreport" the court's legal conclusions to the public. The plaintiffs have made a number of allegations against the defendants. This opinion finds that some of them may not be presented to a jury, and that others can be. That is all. The sole aim of this opinion is to determine whether a juror, if he believed the plaintiffs' evidence and the most reasonably favorable interpretation of it, could decide the case adversely to defendants. It goes without saying that no juror is bound to hold against them because of anything we say or do here. The court is very concerned that

the press exercise extreme care in advising the public of the very limited nature of our inquiry, so that no needless prejudice will attend the parties' quest to draw a fair-minded jury from the seven counties in our federal division. We believe that the press has done a good job in this respect, and will continue to do so throughout the remainder of these proceedings. We would feel very uneasy, this close to trial, to release these opinions without appropriate cautions. With this in mind, we will proceed to examine the record on defendants' motions for summary judgment under Rule 56 of the Federal Rules of Civil Procedure.

II. COUNT I: RETURN OF FEES PAID BY THE CO-OP

Defendants Ball and Mourton, attorneys at law, and the Arthur Young accountants, have moved for summary

judgment on the trustee's cause of action under Count I of the Consolidated Complaint, wherein he asks for a return of all moneys spent by the Co-op for the defense of Jack White and Gene Kuykendall in a federal criminal action styled United States of America v. Jack White and Gene Kuykendall, CR-80-20028-01, 20028-02, (W.D. Ark., Sept. 5, 1980 - January 23, 1981), affirmed, 671 F.2d 1126 (8th Cir. 1982).

The basic facts have previously been set forth in this and court's opinion, Robertson v. White, et al., 633 F. Supp. 954 (W.D. Ark., 1986). The parties have amplified the record for purposes of their motions for summary judgment on this count, and the court, necessarily, will too. We understand that the test for granting a summary judgment after Anderson v. Liberty Lobby, 59 U.S.L.W. 4755 (June 24, 1986) requires the court to examine the record to

determine whether a reasonable jury could find in favor of the non-moving party on his claim or defense. Our analysis will therefore be conducted along those lines. This opinion will primarily treat the arguments advanced by Ball and Mourton. The court believes that an extended treatment of their claim provides the easiest entree into a discussion of the motion made by Arthur Young and the Creekmore "submission". (Carl Creekmore's July 22, 1986, motion for summary judgment does not specifically address the Count I claim; it will be addressed tangentially in this motion.)

On September 5, 1980, the Grand Jury indicted White and Kuykendall for wilfully subscribing a corporate tax return which they knew to be inaccurate in material respects (2 counts) and for conspiring to violate 26 U.S.C. Sec. 7206

by filing a materially inaccurate return (1 count). The indictment said that Jack White had engaged in a course of self-dealing activity with the Co-op, and had disguised his conduct by submitting a false return. It is true that the indictment did not charge him with self-dealing, per se. There is no federal crime of self-dealing. But at the very basic level of wanting to know "what they said he did," a person would be justified in reading the indictment as having alleged that Jack White had been involved in self-dealing with Co-op assets. Indeed, another reading of the indictment would be technically correct, but such a perfection in understanding the indictment is inessential for these purposes, which only seek to determine whether a reasonable person would have suspected or concluded that White's stewardship of the Co-op was under fire.

Taking that as our measure, we apprehend that the Grand Jury substantially averred that Jack White operated the Co-op's business on numerous occasions at less than arm's length. This is the conclusion drawn by the court of appeals, United States v. White, 671 F.2d 1126, 1128, (8th Cir. 1982) ("the indictment charged that White had engaged in a course of self-dealing"). It would be obviously futile to suggest that a reasonable jury could not find, as a fact, that the indictment put persons on notice of White's history of self-dealing, in the face of the Court of Appeal's characterization of it.

On September 8, 1980, the Co-op met with Ken Mourton, who discussed the indictment with them. Following questions by the Board, the directors passed a resolution expressing confidence in White, stating that there was "no money missing"

from the Co-op. On December 11, 1980, the directors passed a resolution authorizing the Co-op to pay the legal fees and expenses incurred by White and Kuykendall. The petit jury convicted the defendants on all counts on January 23, 1981, after a fourteen day trial. The court of appeals affirmed the judgment on February 26, 1982.

The record would support a reasonable jury's finding that the I.R.S. began an investigation of the Co-op in December, 1976, and in February, 1977, decided that the transactions it had examined merited screening by its criminal investigation division. In May, 1977, Jack White asked the Board for authority to hire tax specialists for the Co-op which, at that time, was itself under civil and criminal tax investigation by the I.R.S. The Co-op authorized White to do this, and on May 16, 1977, the Co-op hired E. J. Ball

and Ken Mourton, d/b/a Ball and Mourton to represent it in the on-going investigation covering calendar years 1973, 1974, and 1976. (BMA Statement of Undisputed Facts, Par. 18). The Co-op continued to use the services of Ball and Mourton up until the Co-op filed for bankruptcy in February, 1984. Thereafter, the bankruptcy court retained Ball and Mourton for the estate until October, 1984. Id.

A reasonable jury could find that experienced men of affairs, at the highest levels of their professions, would understand the indictment as alleging that White had self-dealt with the Co-op; furthermore, on the record, such men would have been able to appreciate the dimensions of the Government's complaint at some earlier time, since there were numerous meetings with the Government in the pre-indictment stage. An objective review of

some of the transactions giving rise to the 34 "overt acts" in the conspiracy count would reveal a pattern of unlawful fiduciary behavior practiced by White, the Co-op's general manager. (Indictment, BMA Exhibit 14, pp. 378-79). For example, in 1974, the City of Van Buren, Arkansas, financed the construction of the modern Co-op complex by issuing \$1.5 million in Act 9 bonds. Jack White bought them all. The Co-op loaned White \$1.5 million at no interest to buy them, and paid 8% interest to him as a bondholder. White took the interest in lieu of his yearly bonus, as we understand the testimony of the criminal trial, so the deal is not quite as bad as it sounds. However, to this date, no one has suggested a plausible explanation why it was advantageous for the Co-op to structure the transaction in this way. Had the Co-op kept its \$1.5 million and sold

the bonds, or even tried to, it would still have saved "property taxes" and would still have paid the same "low" interest rate [Ball, Affidavit, Para. 11 (e)(i) and (ii)]. By using its own money at 8% from note holders (the rate paid notes from May, 1974, to September, 1976, when it dropped to 7% [Ball, Affidavit, 916(f) p. 9]) in order to loan that same money to White, so that White could indirectly loan that same money back to the Co-op at 8%. The Co-op paid 7% to noteholders from September, 1976, to July 1, 1977; so for a time the Co-op paid White more. In any event, there is one clear winner here: Jack White. It appears from this scenario that the aim and end of this transaction when all the corn has been shucked, was to give Jack White tax-free income. Certainly, he did not energetically market bonds, and had no incentive to. The corporation would have

had an incentive to have the bonds marketed, since that would replenish funds taken from current assets. As the transaction stood, demand note funds were used to purchase long term assets, depleting the current ratio. At the very least, the corporation suffered an adverse effect on its current ratio in order to give White tax-free income.

One question, therefore, bothers the court: if this transaction were bona fide, why have all the lawyers and accountants failed to come up with a plausible reason for it? The lawyers and accountants obviously have a motive for advancing such an explanation if it exists, since otherwise they run the risk that a reasonable jury may conclude that experienced men of affairs read and understood the indictment in its general signification, and that they furthermore,

upon investigation and reflection, could have determined that the allegation that White profited at the expense of the Co-op was probably true. Such a conclusion has serious implications for the resolution of motions under Count I of the complaint. The court does not gainsay that criminal defense counsel have the undoubted right vigorously to contest any adverse characterization of a client's activities or motives by the Government; that, in fact, is their duty, upon the performance of which all our liberties depend. That is not in question. Count I asks the question from whom such an advocate may expect his pay after he is done saying his piece. Can a lawyer reasonably expect a corporation harmed by his client's activities to pay legal fees for defending the client against a criminal indictment which calls into question the very acts which harmed it?

The indictment, in fact, exhibits a pattern of such conduct engaged-in by White and Kuykendall. In another example, in 1974, the Co-op stored surplus fertilizer at a time when Nebraska farmers were facing a shortage. The Co-op through White arranged to sell the product at a premium price. Not all the receipts from the sales were recorded as belonging to the Co-op. Instead \$240,000 of the receipts found their way into demand note accounts of fictitious individuals. It is possible for a jury to conclude that this was done, as White and Kuykendall swore, to create a "reserve" for fertilizer which "caked" in the Co-op's storage bins that summer, although the juror would have to wonder why the artifice of the bogus accounts was created for this purpose.

Contrarily, a reasonable juror could conclude that this artifice was

intended to benefit White. Soon afterwards, \$225,000 was moved back into the Co-op when the bogus noteholders "bought bonds." White's loan account was reduced \$225,000. The Co-op paid the bogus noteholders 8% interest on their "bonds." Could not a reasonable jury conclude that the imaginary demand note accounts were created in order to give White access to the funds?

The court believes that on balance a reasonable juror could conclude that this artifice was contrived in order to benefit White, and that a reasonably experienced professional would grasp this almost immediately. The jury which convicted White and Kuykendall may very well have concluded that White's "caked fertilizer" explanation did not hold water. First, the suggestion that defendants created a "reserve" for ruined fertilizer did not

surface until long after the investigation commenced. Second, the weather data did not support the defendants' contentions. The very kindest interpretation one can put on matters is that White and Kuykendall hatched this scheme simply to save the Co-op some taxes, since the sales to the Nebraska farmers were non-patronage-based and therefore fully taxable. Of course, this interpretation ignores the fact that such a goal could have been achieved more simply and expediently, with no devious devices at all, simply by making the Nebraskans members of the co-operative. Alternatively, White and Kuykendall may have wished to avoid making the Co-op pay a "patronage dividend" to the Nebraskans, which would have had to have been done if they paid \$10.00 to become members. The court believes that a reasonable jury may come to a conclusion which is more easily

understood in these parts: that the bogus accounts were created so that White could draw on and use the money between July, 1974, and January, 1975. The court has examined the accounting system used by the Co-op for demand notes, and believes that in the case of a fictitious payee, it would be more than possible to, in effect, "keep two sets of books," using the money at will, and to create an essentially bogus paper record of the transactions, because there appears to have been no effective controls which would have prevented that from happening.

The relevance of this discussion to our problem is that the allegations in the September 5th indictment are such that a jury may reasonably conclude that BMA were actually aware that White had pursued a course of action inimical to the Co-op, or at least were on notice of the potential

conflict. Nor were these two examples the only ones. The indictment also alleged that White borrowed \$1.2 million from the Co-op at ten percent, only to turn around and loan it to his associates at twelve percent. The court does not intend to enter the lacunae of whether this opportunity was truly a corporate opportunity which White misappropriated. The issue is: how can a corporate servant conscientiously pursue his duty to get the most for his master's dollar, when he intends himself to loan that money to a third party and make a profit for himself?

The court believes, in short, that a jury could find that possibly in 1977 when Ball and Mourton first agreed to work for the Co-op, and almost certainly by 1978, when the attorneys were briefed as to the dimensions of the criminal case by the I.R.S., Ball and Mourton were in a position

to appreciate the conflicts, real and potential, in representing both White and the Co-op.

Ball and Mourton appear to concede the applicability of Raines v. Toney, 228 Ark. 1170, 313 S.W. 2d 802 (1958) to this question. They suggest that Raines holds that third parties (presumably, in this case, Ball and Mourton) may be liable to a plaintiff whose fiduciary injured him, only if the third party knowingly assisted the corporate officer in breaching his duty to the plaintiff. The BMA brief questions whether the record supports that (a) White breached a fiduciary duty to the Co-op by accepting indemnification for his legal expenses, and (b) whether BMA knowingly assisted him in doing so. (BMA, Brief, p. 7).

The case at bar is far stronger than Raines v. Toney, supra. Here, the

third party is itself a corporate fiduciary. Here, the third party received the full benefit of the moneys misappropriated from the Co-op to indemnify White, contrary to law. The case brought by the Trustee is stronger, by far, than the one brought by the bankruptcy trustee in Proctor v. Norris, 188 N.E. 625 (Mass., 1934). In Proctor, one MacClaskey controlled the bankrupt Phoenix Bond and Mortgage Co., and also owned an interest in a concern called Hodgdon, Cashman & Co., which was in financial straits, to the extent that some of its customers were asserting claims against MacClaskey personally. In December, 1927, MacClaskey went to defendant, a newly licensed lawyer, and told him that he wished to pay Hodgdon-Cashman creditors out of his own pocket in a way that Cashman would be required to repay the lawyer. The attorney, Norris,

set up a trust account from which to pay creditors at MacClaskey's direction, and agreed to receive from Cashman notes for the amounts of the checks. MacClaskey told Norris that he wanted Cashman to believe that Norris himself was extending credit to Hodgdon-Cashman, and Norris undertook the task, believing MacClaskey was using his own funds as represented. Id., at 626.

In fact, without authority, MacClaskey drew checks to the lawyer's order out of the Phoenix Bond & Mortgage Co. account, signing them as Treasurer. The court found that Norris, though acting honestly and though ignorant of whether Phoenix Bond was a corporation or not, could easily have discovered the truth. The court determined that the defendant knew that the checks were drawn for a purpose unconnected with the business of Phoenix Bond, and charged the lawyer with

notice that MacClaskey (who was president, treasurer, majority shareholder, and [essentially] the total board of directors of Phoenix) was not empowered to draw off corporate funds in order to pay Cashman's creditors. Pointedly, the court observed that the defendant "though acting honestly and though ignorant as to whether the company was a corporation or not, could easily have discovered the truth," Id., at 626. The court noted that even with innocent purpose, the lawyer knew that the checks were unconnected with the business of the Phoenix Bond and Mortgage Company, and was chargeable with notice that MacClaskey probably had no right to draw them. The defendant was therefore considered by the court to have come into possession of funds belonging to the corporation, and to have assisted

MacClaskey in diverting them to an unlawful use. Id.

The Proctor court deemed it irrelevant that the young lawyer had not received the money for his own benefit. "An agent of fiduciary who receives trust property and disposes of it in a transaction beyond the legal powers of the fiduciary is liable as a constructive trustee to the beneficiary," the court decided. Id. As a concluding matter, the court noted pertinently that "the failure of the directors of the ... company to perform their duties could not give MacClaskey any right to divert corporate funds, or estop the corporation, the stockholders, or the plaintiff to seek their restoration." Id., at 627.

We believe Proctor v. Norris, supra, to be a correct statement of the law, and to the extent that the case at bar

differs from it, it does so in ways inclining the balance even more favorably to the Trustee. First, in this case Ball and Mourton were Co-op fiduciaries at the point they undertook White's representation and the Co-op's pay; in Proctor, the lawyer owed no fiduciary duties to the Phoenix Bond and Mortgage Co. Second, in this case Ball and Mourton received the misappropriated moneys; in Proctor, the lawyer disbursed it at MacClaskey's instructions. Third, Ball and Mourton were in a superior position to observe and conclude that the fiduciary White had breached his duties to the Co-op, or at the very least had failed to comport himself with "a punctilio of fairness the most honest"; whereas the Proctor defendant appears successfully to have been deluded, and at the very least was never shown an indictment to arouse his suspicions. To

the extent that there is a difference, it is this: here the Board passed a resolution, there it didn't. The Proctor report persuasively suggests that such a resolution would have been a mere formality in that case. There is persuasive evidence in this case that Ball and Mourton considered the board's consent to the arrangement to be no real impediment to the plan: months before the indictment was issued (itself three months before the board passed the December 11 resolution) Ball and Mourton decided that they faced a conflict in representing Kuykendall. Ball then called Hugh Hardin, a Fort Smith lawyer, and asked him if he would represent Kuykendall, telling him that the Co-op would pay the fees for it. Kuykendall was never an officer or employee of the Co-op. He had not even a colorable claim for indemnity under the statutes. For some

reason which Ball and Mourton's summary judgment motion does not address, the Co-op's lawyer was evidently confident that the cooperative would pay Kuykendall's fee; so obviously he must have been confident that it would pay his own. The fact that the Co-op board sealed the pact with no real debate hardly suggests that the result in this case should be different as a matter of fact and law than the result in Proctor.

That is, simply because directors abdicate their fiduciary responsibilities to shareholders does not excuse the Co-op's lawyers from their duty independently to investigate the propriety of the payment. The indictment was sufficient notice to Ball and Mourton that a conflict existed to enable the court to say that they ran the risk that they might be deemed constructive trustees to the Co-op. This

is most especially so in the case where bankruptcy intervenes. The trustee may prosecute a cause of action based on an unlawful diversion of assets or on a statutory liability created by the law of the state of corporation. That an officer's conduct has been ratified by the board does not avail the defendant. Neese v. Brown, 405 S.W. 2d 577 (Tenn. 1964), noted 35 Tenn. L. Rev. 673 (1968). The trustee loses his rights only where the transaction sued upon has been ratified by all the stockholders. Field v. Lew, 184 F. Supp. 23 (E.D.N.Y. 1960); See also, Cunningham v. Jaffe, 251 F. Supp. 143 (D.S.C., 1966). These cases evidently take the position that a shareholder "always could" sue derivatively to recover the assets diverted, and because that power existed "in the right of the corporation" e.g. Ark. Stat. Ann. Sec. 64-223 (1980

Repl.), no action by the board of directors can remove the issue from litigation.

The court therefore believes that summary judgment should be denied Ball and Mourton on Count I of the Complaint. On the law, the trustee succeeds to any right which the corporation had. Certainly White had no right to indemnity under the corporations act. Such a claim could only be justified where White acted "in good faith" in engaging in the underlying conduct. Given that this underlying conduct may reasonably be found to have been "self-dealing," a Co-op shareholder could have sued at any time, derivatively, to require White and other recipients to disgorge the fees. In such a circumstances, a court may ultimately defer to a board of directors' decision, but it is not required to. Certainly if a court concluded that White's 1973-77 activities

as listed by the indictment constituted self-dealing, it would be difficult to conclude that he acted in "good faith" and therefore impossible to defer to the directors' decision. A court would have to conclude that White breached a fiduciary duty by accepting benefits contrary to law. CF. Assoc. Milk Producers v. Pair, 528 F.Supp. 7 (E.D. Ark. 1980) (semble).

Having made that determination, a jury could conclude that Ball and Mourton took their fee from the Co-op knowing far more than anyone the presence of actual and potential conflicts presented by White's activities from 1973 through 1977. They therefore assisted and profited from White's acquiescence in a benefit to which he was not entitled.

Concerning the defense of limitations, we are persuaded that the three year limitation applies. Ark Stat

Ann Sec. 37-206 (Repl. 1982). Cooley v. First National Bank, 276 Ark. 387, 635 S.W. 2d 250 (1982). McGhee v. Glenn, 244 Ark. 1000, 428 S.W. 2d 258 (1968). (action to recover money paid by mistake barred in three years). Ball and Mourton continued representing White on his criminal indictment on through March, 1982. Presumably, they were paid for this work by the Co-op. They failed to show, therefore, that all of the money received by them was disbursed prior to February 23, 1981, the relevant date for purposes of computing limitations on claims brought by the trustee. Under a "continuing wrong" theory (among others) any wrongful receipt of moneys pursuant to an initially wrongful breach of fiduciary duties tolls the limitations period. The defendants Ball, Mourton and Adams' motion for summary judgment on Count I is therefore denied.

Arthur Young's motion stands on slightly different footing. First, they did not receive their fees as fiduciaries of the Co-op. They were witnesses hired by Ball and Mourton and owed no duties to the Co-op during the time they were so engaged. Second, Arthur Young did not ever arguably "assist" the breach of White's fiduciary duties. That is, it may be argued that Ball and Mourton, attorneys for the Co-op, "assisted" the breach of the duty by failing to advise the Co-op when they were otherwise under a duty to speak. (This issue was not resolved in the Ball and Mourton discussion, and is only included here for purposes of analysis.) Unlike the lawyers, the accountants had no duty to advise the Co-op on the question whether it should pay White's fees and expenses. The Arthur Young defendants are the most passive vessels among the parties sued in

Count I. The directors who were sued passed the resolution authorizing the payment; White and Kuykendall directly benefitted and had a duty to disclaim the benefit arising out of their relationship to the enterprise; Creekmore, the Co-op counsel, presented the resolution for approval and did not (at least) counsel against its passage, and thereby assisted the breach by failing to discharge a positive duty he owed, then and there, to his client; finally, as we say, Ball and Mourton failed to correct their client's appropriation of the money, and directly benefitted from that failure. In no sense can Arthur Young's conduct in this circumstance be likened to any other party's.

In our view that does not matter. Arthur Young has argued that Count I charges asserts "some kind of tort claim"

and protests that "it is a mystery what text Count I purports to assert. . . but it is clear that no viable claim is asserted. Count I alleges only that Arthur Young 'knowingly received' money for professional services -- a not surprising fact and one that does not normally constitute tortious conduct.'" (AY Motion to Dismiss, pp. 8-9).

The court believes that a reasonable jury can find the following: (1) that sometime in 1980, Ball and Mourton hired the Russel Brown (now Arthur Young by merger) firm to provide litigation support to it in the criminal trial of Jack White; (2) that the primary parties to the contract of employment were Ball and Mourton as "parties of the first part" and the Russel Brown accountants as parties of the second; (3) that Ball and Mourton told them that they would be paid by the Co-op,

but that the parties knew that the employing party, Ball and Mourton, would remain primarily liable; (4) that this conversation pre-dated the Co-op's December 11 resolution authorizing the payment of fees for White and Kuykendall; (5) that Arthur Young thereafter knowingly received fees from the Co-op (as opposed to fees distributed through Ball and Mourton's Trust Account); (6) that Arthur Young was fully ware that there had been alleged that White had improperly benefitted from what accountants refer to as "related transactions" and therefore was aware, or should have been aware, that the receipt of fees was a related transaction within the meaning of that term; and, (7) that Arthur Young, in August 1981, after having received fees from the Co-op in January, 1981, accepted an engagement to audit the cooperative's statements, one part of which

would include passing on the propriety of the payment of White's fees.

Under this analysis, which a reasonable jury could entertain, Arthur Young should have been aware, similarly to the lawyer in Proctor v. Norris, supra, that reimbursement for its services ought to have come from Ball and Mourton in the first instance. They accepted the money notwithstanding its source, and notwithstanding the context; i.e., that they were being paid by the Co-op for the benefit of White against whom allegations of self-dealing had been made.

A reasonable jury may conclude that Arthur Young's acceptance of such funds from a party only secondarily liable (if at all) on the contract between them and Ball & Mourton was such as should have alerted them to the questionable propriety of the arrangement. If the payment be

questionable in any case, a jury might reasonably conclude that it is highly questionable in a context where the firm provided services to a corporate employee who was substantially charged with self-dealing, particularly where they were in a position to learn the full details of those transactions (notably the Act 9 bond transaction,) the bona fides of which they are to this day unable to explain (or have chosen not to at this time.)

A reasonable jury may conclude that the Arthur Young defendants became corporate fiduciaries (within the scope of their employment) when they engaged to audit the cooperative's financial statements in August, 1981. As fiduciaries (within the scope of their services) Arthur Young was obliged to pass on the propriety of payments of which they were beneficiaries, and therefore had a duty to

investigate anew the propriety of that payment. A particularly disturbing question is presented in this connection. If the Co-op could legally have made advance payments for White's defense in a criminal case, the statutes seem to require the officer benefitting from that arrangement to indemnify the corporation in the event that he is convicted or in the event that the payment be otherwise objectionable. The use of the word "advance" in the statute conjures up the image of a "loan" to the officer; that is, something that should be paid back. This "loan" however was never made to the officer; rather, it was made to the accounting firm. Leaving all questions aside whether a payment can be termed a "loan" when it was made for services rendered, by legal analysis the obligation was theoretically callable by the

corporation directly or by any one of its shareholders derivatively from the accountants for a period of at least three years after the last payment was made, unless the limitation be otherwise extended. Under that analysis, the payment to Arthur Young is "loan-like," since under that analysis Arthur Young would be required to pay the amount back to the Co-op and make its demand for payment on the parties primarily liable: i.e., Ball and Mourton, or Jack White. To what extent is an auditor independent (See, S.E.C. ASR 234)<sup>1</sup> under that characterization of the problem? If he is not "independent" under that characterization, can he pass on the propriety of that transaction in his audit?

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<sup>1</sup> This Accounting Series Release was recalled by the Securities Exchange Commission in 1981, not because it misstated any principles, but because it was deemed unnecessary.

Does he "toll" the statute of limitations against him, in other words, by issuing an audit report a year later which is silent on whether his services as an expert witness constituted a "related transaction" which needed investigation and/or correction? This consideration impels us to deny Arthur Young's plea of the statute of limitations, which would otherwise be availing since the accountants received their fee more than three years before the commencement of the bankruptcy proceedings. The question of limitation can be, of course, submitted to the jury for decision if Arthur Young so desires.

For these reasons, then, Arthur Young's Motion for Summary Judgment under Count I is denied.

### III. COUNT II: FRAUD, NEGLIGENCE, AND CONSPIRACY IN TRANSFER OF GASOHOL PLANT

#### A. The Motion of Carl Creekmore

Carl Creekmore, former general counsel of the Farmers Co-op of Arkansas and Oklahoma, Inc., has moved for summary judgment on claims of negligence, fraud, and racketeering brought against him by the bankruptcy trustee for the Co-op, and by the class of members and noteholders of the Co-op. An earlier opinion of the court, Robertson v. White, 683 F. Supp. 954 (W.D. Ark. 1986), recited in some detail the allegations against all the defendants in the case. It will not be necessary to repeat all of those. The court will go into greater detail concerning the critical facts surrounding the transfer of the White Flame gasohol plant to the Co-op, and particularly those circumstances and actions involving Creekmore. Our goal in

this recital is to make the kind of findings a reasonable juror could on the basis of the record presented. See Anderson v. Liberty Lobby, 54 U.S.L.W. 4755 (June 23, 1986). This is not to say that these "findings" are incumbent on any juror; only that they represent the most favorable findings and inferences a reasonable jury might draw from the conflicting accounts advanced by the parties.

Towards the middle of 1979, Jack White, general manager of the Farmers Co-op, and Edwin Dooley, a Fort Smith businessman with experience in oil and gas, resurrected an old corporation, Big D Solvents, with the idea of building and operating a gasohol plant to make automotive fuel from agricultural products. The two got a loan from the Merchants Bank of Fort Smith and commenced planning the

enterprise. White suggests that the one-half interest he owned was always the Co-op's, but a reasonable jury could decide otherwise, since there is scant documentation of his assertion. Furthermore, he claimed White Flame's entire loss on his 1979 taxes. In the fall of 1979, Dooley decided to leave the enterprise, and White bought him out, taking a loan from the Citizens Bank of Van Buren. Both White and Creekmore were directors of the Citizens Bank. The loan from Citizens was close to its lending limit for individuals, and when, a year later, it still remained unpaid, the Bank made demands on White.

To get the plant built and into operation, White figured that he would need \$3 million in financing, and sought to sell some Act 9 bonds to raise the money. Accordingly, the Little Rock firm of

Friday, Eldredge & Clark was engaged to prepare the papers requisite for that purpose, including an offering statement. A reasonable juror could conclude that Creekmore was acting as White's attorney in this matter, since the Friday firm sent materials to Creekmore under cover of a letter identifying him as White's attorney (Plaintiffs' Ex. 178). The offering statement, a copy of which was given to Creekmore, was hairraising. It is safe to say that none but the most foolhardy would ever have bought bonds whose repayment depended on the success of the gasohol plant.

The court will excerpt certain statements from the bond counsel's report so that one may get a flavor of the discouraging nature of the enterprise. In bold type, the statement says that in the opinion of bond counsel, the bonds were not

suitable for investment purposes because of their high risk. Counsel cautioned that the bonds should not be purchased by anyone who could not afford a complete loss of the investment. Inasmuch as Jack White individually was being called on to guarantee the bonds, the statement alerted the reader that one should be wary of the guarantee since it was uncertain that White had the resources to pay it off. Under the terms of the statement, the Farmers Co-op was supposed to buy the bonds, and presumably these cautions were being addressed to the Co-op and anyone purchasing bonds from it.

The offering statement went on to relate that the bonds involved an unusual and substantial degree of investment risk, that they were not suitable for the general public, and that the entire investment stood to be lost. It related that the

company was a new entity with no operating history of any type, whose management had no experience, proposing to use an untried process with no assurance of mechanical success. The Company, related the statement, had no contracts to purchase raw materials and no market for its product. The Company had no resources at its command other than the bond proceeds, no personnel with technical proficiency, and no assured demand for its product. The statement exceeds 40 pages, and is as discouraging a report as one is likely to find.

White dropped the idea of selling bonds to the Co-op at this point, or to anyone for that matter. He began financing the operation out of Co-op cash funds, making notes to it for many hundreds of thousands of dollars at a time, with no security other than his "guarantee." These loans were never authorized by the board.

From January, 1980, through October, 1980, they totaled over \$4 million.

White claims that in February, 1980, the Co-op Board of directors voted to buy the gasohol plant, and Creekmore goes along with this, although he does not recall the exact circumstances of the transaction. A reasonable jury would not be obliged to believe this, however. The minutes are silent on the point, the directors hazy, and the subsequent course of events contrary to the hypothesis. For example, White guaranteed notes from the Co-op to White Flame Fuels (as it was then called) and pursued FmHA financing for the project in his own name, representing the facility as his own. In addition, one board member recalls that a motion was made and seconded to buy the plant in February, but that the motion was withdrawn at the

request of Jack White. (McClure Depo., at 118).

Significantly, the contents of the offering statement were never shown to the Co-op by White or by Creekmore, both of whom were fiduciaries. The law required such a statement to be shown to the board of directors in the event that they were to buy the Act 9 bonds. Of course, in a non-securities transaction, no such statement need be shown. As disclosed later, however, the Co-op, in supposedly buying the plant, purchased the stock of White Flames Fuel. The kind of disclosures mandated for securities transactions of that type, however, were never made. See Landreth v. Landreth Timber Co., 105 S.Ct. 2297 (1985).

The gasohol plant began production in April, 1980. All the dismal forebodings of bond counsel were fully realized. The

plant, plagued with cost overruns, glitches and snafus, could never sustain production over 25% of capacity, and lost \$100,000 a month. Understandably, White was unable to attract FmHA financing for the plant.

In November, 1980, the Co-op board went on record, voting to buy the gasohol plant. The minutes are no more spacious on the subject than that. The record discloses no certain terms, price, time, or anything else considered essential for purposes of contract. White claims that this action was taken to memorialize the February vote. A reasonable jury could conclude otherwise. Evidence shows that a Farmland representative visited the Co-op in November to advise them that they should not buy the gasohol plant, and that he was told by White that the plant was still owned by him.

Two weeks after the Co-op voted to buy the plant, Jack White, Hugh Brewer (chairman of the Co-op board), Carl Creekmore,<sup>2</sup> E.J. Ball (White's attorney on criminal tax fraud charges), and Hugh Hardin met in Hardin's office in Fort Smith. It had been learned that the Co-op might take advantage of certain tax deductions available to the gasohol plant if it could be shown that the cooperative owned the plant prior to the date it commenced production. White and Brewer volunteered that such was the case, and informed the lawyers, Ball and Hardin, that the Co-op had voted in February to buy the plant, but that the vote had not been recorded in the minutes.

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<sup>2</sup> Creekmore denies attending this meeting, but the testimony of Ball and Mourton places him there. For purposes of summary judgment, such evidence would allow a reasonable jury so to find.

Lacking any documentation to show the IRS, in the event that the propriety of the deductions were ever questioned, Ball suggested that the Co-op file a "friendly lawsuit" against White, the purpose of which was to establish ownership by the cooperative on February 15, 1980, more than a month before the plant commenced production.

Creekmore told the lawyers that he lacked expertise and asked Ball, who worked in Fayetteville, to prepare the papers. Hardin volunteered to draft the complaint for the Co-op and deliver it to Creekmore. On November 26, 1980, Hardin delivered the first draft of the complaint to Creekmore, Ball and Gene Kuykendall. This draft recited that on January 1, 1980, White and the Co-op agreed that White should assign his stock to the Co-op, and that the sole consideration for the transfer would come

out of the net profits of the plant from 1980 to 1985, but in no case more than \$250,000. The complaint recited that in reliance on that agreement the Co-op advanced \$3.85 million to the plant, but that White refused to tender the stock. The complaint sought a declaration confirming the deal as outlined in the pleading, and an order requiring White to turn over the certificates to the cooperative.

This draft evidently did not satisfy Ball, possibly because the date of the agreement was January 1, 1980, rather than February 15. The complaint was redrafted so that the Co-op became obligated to pay White's \$250,000 note to Citizens Bank. Besides that, the complaint recited that the entire amount advanced to the plant as loans guaranteed by White would be "considered the [cooperative's]

investment" in the plant. This amount apparently ran to \$750,000. The complaint then recited that since February 15, 1980, the Co-op had advanced another \$2.98 million to the plant. It asked for a declaration that the stock of the gasohol plant belonged to the Co-op, and that the "deal" be confirmed along those lines.

At the December, 1980, board meeting Creekmore announced his retirement, effective December 31, 1980. He made a report to the board concerning pending litigation, and told them that, in addition, the Co-op's tax lawyers (Ball and Mourton, of Fayetteville, Arkansas, also White's criminal tax attorneys) had recommended that he file a declaratory judgment action to establish the February 15 transfer date. Creekmore avers that he fully informed the board of the terms of the lawsuit; the directors, however, though

recalling that the subject of such a lawsuit came up, do not testify that they were fully aware of the intents, purposes, and effects of the suit.

The board passed a resolution empowering Creekmore to do whatever was necessary to get the stock in the Co-op's name, but did not specify that a lawsuit be filed. The next day, Creekmore filed the declaratory judgment action, and the following week, after White filed an answer generally denying the allegations of the complaint, Creekmore, White, Brewer and N.D. Edwards, a Van Buren lawyer recruited to represent White at the hearing, procured a decree from the Chancery Court vesting title to the stock in the Co-op's name, and absolving White of all liabilities. By this time, the gasohol plant was a money pit.

The record is clear that at no time did Creekmore ever reveal to the board that he simultaneously represented Jack White, nor did he ever reveal to the board the information contained in the offering statement concerning the advisability of investing in the gasohol plant. The trustee complains that Creekmore's complicity in this affair constituted negligence, fraud and racketeering, as those terms are understood in the common law, as well as under state and federal securities and racketeering statutes. Creekmore argues that certain of the allegations, notably those of fraud and negligence, are barred by the statutes of limitation, and that the evidence does not show federal securities law and anti-racketeering violations on his part.

On February 23, 1984, the Co-op filed for reorganization under Chapter 11 of the bankruptcy code. A principal question for decision under Creekmore's motion for summary judgment is whether he is chargeable with any act occurring on or after February 23, 1981, that would toll the running of the statute of limitations. Under 11 U.S.C. § 108, statutes of limitations barring a bankrupt estate's causes of action against third parties are automatically extended two years, unless such actions were already barred by the time the reorganization proceedings commenced. In addition, so far as relevant, the class filed its claims of fraud against Creekmore on May 8, 1985. These matters of limitations for the common law counts of negligence and fraud will be taken up first.

(1) STATUTE OF LIMITATIONS

A. COMMON LAW

I. Negligence

The statute of limitations in Arkansas for negligence actions against attorneys is three years. Ark. Stat. Ann. § 37-206 (1962 Repl.). In Riggs v. Thomas, 283 Ark. 148, 671 S.W.2d 756 (1984), the Supreme Court of Arkansas ruled that the limitations period began to run, absent concealment of the wrong, when the negligence occurs, not when it is discovered by the client. Concealment, however, may not be found when a tortfeasor merely remains silent or fails to publish the fact that he has committed a wrong. Scroggins Farms Corp. v. McFadden, 165 F.2d 10 (8th Cir. 1948). To toll the statute, some affirmative act needs to be done, unless there is a duty to speak. Williams v. Purdy, 223 Ark. 275, 265 S.W.2d 534

(1954). Generally speaking, knowledge of the wrong done is a necessary prerequisite to a tolling of the statute of limitations by reason of concealment. Cf. Williams v. Edmondson, 257 Ark. 837, 520 S.W.2d 260 (1975). That is, one cannot negligently conceal a negligent tort so as to be deprived of the benefit of the limitations defense. An attorney is under no special obligation merely by virtue of the attorney-client relationship to alert his client that he has negligently performed a task so as to prevent the running of a statute of limitations. E.g., Fortune v. English, 226 Ill. 262, 80 N.E. 781 (1907).

There does not appear to be any allegation that Carl Creekmore concealed his responsibility for negligent acts. First, in our opinion denying the motions to dismiss, Robertson v. White, supra, at 959, we criticized the plaintiffs'

complaint for not alleging particular acts of concealment which would take their cause of action beyond the bar of limitations, citing Stewart Coach Indus., Inc. v. Moore, 512 F. Supp. 879 (D. Ohio 1981). We indicated that the limitations questions would likely re-arise on motions for summary judgment, and counsel were alerted to file statements of non-disputed facts pursuant to Local Rule No. 29 as a means of sharpening the concealment issue. To the extent that plaintiff has filed a Rule 29 statement, it is a non-conforming one. Rather than recite material, undisputed facts, it asks a series of argumentative questions, i.e., "What level of expertise can be expected of a former judge (for 20 years)? May he simply defer blindly to other lawyers representing conflicting interests who now disclaim having even researched the matter, etc.?" One searches

in vain for any act of concealment charged by the plaintiff's Rule 29 submission. Creekmore's Rule 29 submission advises that he left the employ of the Co-op on December 31, 1980, and that he last worked on the transaction in question on December 19, 1980. He further says, "At [the Board meeting of December 11, 1980] Creekmore advised the Board that it had been recommended that he file a Complaint on behalf of the Co-op against Jack White and White Flame Fuels, Inc., and obtain a declaratory judgment on the transfer of the gasohol plant to the Co-op. Creekmore then advised the board of the nature, provisions, and purpose of the proposed lawsuit and the board consented to the procedure." The plaintiff's statement takes no issue with this assertion, but merely questions whether it is true. Under Local Rule 29(c), movant's declarations are

deemed to be admitted unless controverted by the defending party within 10 days.

For all practical purposes, the plaintiff has failed to make a showing on concealment at all. Such a showing must be weighty, if the language of Williams v. Purdey, 223 Ark. at 279, is to be given any effect:

There must be some positive act of fraud, something so furtively planned and secretly executed to keep the plaintiff's cause of action concealed, or perpetrated in a way that it conceals itself. And if the plaintiff, by reasonable diligence, might have detected the fraud, he is presumed to have had reasonable knowledge of it.

In plaintiff's brief opposing Creekmore's motion, pp. 2-11, the trustee recites his version of the relevant, material facts very thoroughly. At no point does the trustee suggest that Creekmore did anything after December 19, 1980. Rather, to extend the period the

trustee argues the following: (1) that a conspiracy existed between Creekmore and members of the board to conceal from later board members the facts surrounding the transfer ("Argument" at 13) so that the transfer could be rescinded; and (2) that Creekmore had a duty to advise the Co-op to file a motion to void the decree within 90 days of its entry, see Ark. R. Civ. P., Rule 60(b), for failure of which the applicable limitations period begins running March 19, 1981, or within three years of the date on which the Co-op filed for bankruptcy, an act which extended the limitations period for non-barred suits, and would presumably save this suit.

The record offers no proof of an agreement between Creekmore and the board members that details should be hidden from members who should later come on board. The court views plaintiff's suggestion that

there was such a conspiracy as merely tendentious. After Celotex Corporation v. Catrett, 59 U.S.L.W. 4775 (June 25, 1986), a party moving for summary judgment is not required to "support its motion with affidavits or other similar materials negating the opponent's claim." Rather, Celotex teaches that the non-moving party must "go beyond the pleadings and by her own affidavits, or by the 'depositions, answers to interrogatories, and admissions on file,' designate 'specific facts showing that there is a genuine issue for trial.'" The evidence which the trustee advances to support his contention that there was a conspiracy among Creekmore and certain Co-op directors to conceal Creekmore's negligence consists of the following two statements from directors, both of whom were not on the board in December, 1980 (Harris and Willis). Harris declared:

Q. Before you found the friendly lawsuit at the courthouse, did you ask any of the members that were still -- that were on the board back in 1980 how the Co-op had acquired the gasohol plant?

A. Yes.

Q. Do you recall which members you asked?

A. At the board room, and as we talked about it, we were asking anyone, at the same time we were talking about how we owned it. Anyone would have had the opportunity to have said "Oh I know" if they knew or wanted to give out that information.

(Harris Depo. at 71).

Similarly, in the deposition of James Buel Willis, the following exchange is found:

Q. . . . did any of the directors that you discussed this with question [the decision to acquire the gasohol plant on February 15, 1980]?

A. The ones I recall that I talked to didn't know any more about the decree than I did.

Q. By that you mean they were not even aware of the decree?

A. That's what I understood. I wish I could be more specific on it, but that's my recollection.

(Willis Depo., at 51).

From these circumstances, the plaintiffs appear to infer or argue conspiracy to defraud. (Plaintiff's Brief at 13). It is clear, though, that in Arkansas, stronger proof of conspiracy is needed.<sup>3</sup> In Fidelity Mutual Life Insurance Co. v. Price, 180 Ark. 214, 220 (1929), the court noted that "in order to establish a conspiracy to defraud, the evidence must do more than excite suspicion; it must lead to belief."

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<sup>3</sup> This discussion concerns only a conspiracy to conceal a cause of action for negligence. The court believes that a jury can find a conspiracy to defraud involving Creekmore.

[emphasis added]. The court said that evidence which was "slight and equivocal" was unsatisfactory for the purpose. In Fidelity Mutual, plaintiffs sued to collect on a policy of insurance which had previously been assigned by the decedent to a bank. The evidence showed that shortly after decedent's burial, a family friend wrote to the insurance company and informed it that the decedent owed no debts to the bank (a former judgment having been taken solely in rem) and enclosed a copy of the court decree. The bank to whom the assignment had been made was owed a considerable portion of the underlying debt, the judgment property being insufficient to satisfy it. As it happened, the officer to whom the letter was delivered was also a director and stockholder in the bank. The evidence showed that the bank had released the

assignment of the policy some time previous to the decedent's demise. Nevertheless, the insurer's officer, Bright, paid the policy to the bank pursuant to the written assignment, and the heirs sued his company and his bank for conspiracy to defraud. In circumstances far more compelling than these here presented, the Supreme Court found there to be no substantial evidence from conspiracy might be found. The court's reference to evidence sufficient to "lead to belief" is the equivalent of "clear and convincing evidence."<sup>4</sup> In the recent case of Kelly v. Kelly, 264 Ark. 865, 575 S.W.2d 672 (1979), the clear and convincing standard was equated with one

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<sup>4</sup> Black's Law Dictionary, 5th ed., p. 141, defines "belief" as "a firm conviction as to the allegation sought to be established."

which produces in the trier of fact "a firm conviction as to the allegation sought to be established." The recent case of Anderson v. Liberty Lobby, 54 U.S.L.W. 4755 (June 23, 1986), says that summary judgment may be entered against a party burdened by the clear and convincing proof standard by "consider[ing] whether a reasonable fact finder could conclude, for example, that the plaintiff had shown actual malice with convincing clarity." Id. at 4758. In making this determination, the court is not to make credibility determinations, but must believe the evidence of the non-movant, and all justifiable inferences are to be drawn in his favor. Id. at 4759. The court does not believe that reasonable jurors could conclude that because two directors were unable in 1982 to obtain information at a board meeting about the

chancery court action in 1980, that it follows in any sense that the other directors had conspired with Carl Creekmore to suppress information about how the decree was taken. This airy chain of inference is forged with links of mist. Anderson says, at the very least, that one who charges conspiracy must offer some "concrete evidence" and may not "merely assert that the jury might, and legally could, disbelieve the defendant's denial of a conspiracy . . . ." Id.

The record, then, discloses no act of concealment by Creekmore, nor by anyone else which would properly be chargeable to him. The trustee suggests, however, that Creekmore's failure to advise the board that it could petition the Crawford County Chancery Court to vacate the decree was an additional act of negligence on his part, which continued, according to the trustee,

until March 19, 1981, which the trustee argues is the last date such a motion could have been made.

The trustee is here referring to Arkansas Rules of Civil Procedure (ARCP) No. 60, which holds that motions to vacate judgments and decrees can be made for specified reasons up until 90 days after the rendition of the decree. ARCP 60(a). That rule provides that a party can obtain relief from a judgment within 90 days of its entry if the party's motion advances grounds which would have been a basis for such relief under prior law upon a motion made before the expiration of the term of court. Such grounds, prior to 1970, were confined to the grounds for a new trial. See Pope's Digest §§ 1536, 1539. These include jury misconduct, accident, surprise, newly discovered evidence, etc., none of which are germane to our inquiry.

Under Rule 60(c)(4) a party may obtain relief from a judgment even after 90 days for "fraud practiced by the successful party in obtaining the judgment." This accords with prior law, which permitted motions to vacate judgments to be filed even after the expiration of the term of court for "fraud practiced by the successful party in the obtaining of the judgment of the court." Pope's Digest § 8246. There is no limitation on such a motion. It could have been brought at any time before or after the term of court under the old rule, or, under the new rule, before or after 90 days.

The question now becomes whether an attorney who negligently represented his client in such a way as to allow an opposing party fraudulently to obtain a judgment against his client can ever

successfully plead the statute of limitations to bar an action of negligence brought against him. Theoretically, according to plaintiff, he never could. A remedial step lies always within his power to initiate. This, of course, assumes that he becomes aware that a fraud was practiced on his client after the judgment was obtained. Under the rule of Williams v. Edmondson, 257 Ark. 837, 520 S.W.2d 260 (1975), the plaintiff must show knowledge of the wrong done, acquired after its commission, in order to argue that the statute should be tolled because of failure to remediate. This record is barren of any suggestion that Creekmore learned of his alleged "negligence" in having obtained the decree, and filed thereafter to inform his client of steps which could have been taken to undo the

damage caused by the chancery court judgment.

For the above reasons, then, summary judgment will be entered in favor of Carl Creekmore against the trustee on all claims of negligence. The court finds that they are barred by the applicable statute of limitations, and that the trustee has submitted no proof of any act of concealment chargeable to Creekmore that would bring his action for negligence beyond the bar of limitations.

## II. Fraud

Creekmore urges that the action for fraud and deceit, too, be barred by limitations. Such act was, also, one governed by the three-year limitations period established by Ark. Stat. Ann. § 37-206. Hughes v. McCann, 13 Ark. App. 28, 31 (1984). Instead of running from

the date of the fraudulent act or misrepresentation, however, the limitations period is not tolled until the injured party could have discovered the fraud in the exercise of reasonable diligence. City National Bank v. Sternberg, 195 Ark. 503, 114 S.W.2d 39 (1938). In cases of fraud involving attorneys and fiduciaries, failure to discover the facts constituting fraud is more easily excused. 37 Am Jur. 2d Fraud and Deceit § 409 at 555.

A 'fiduciary relation' exists between an attorney and his client, requiring the attorney to act in the utmost good faith. The lawyer must not only not misrepresent any facts to his client, but there must be an entire absence of any suppression of facts within the attorney's knowledge which might influence the client. The burden of

establishing the fairness of the transaction is on the attorney. Chavis v. Martin, 211 Ark. 80, 199 S.W.2d 598 (1947).

The trustee has alleged that Creekmore represented conflicting interests in November and December, 1980; those of Jack White, by whom he had been privately employed to help secure financing for the gasohol plant, and those of the Co-op. The trustee alleges that Creekmore never revealed to the board that he had represented White. The trustee alleges that Creekmore failed fully to advise the board of the "pros and cons" of the transaction. The trustee has shown that Creekmore was on notice as early as January, 1980, that the gasohol plant was a financial disaster waiting to happen. White, however, was undeterred by the dire warnings of bond counsel and determined to

"go ahead." He commenced borrowing large sums of money from the Co-op even before February 15, the date when the board supposedly voted to buy the plant. Creekmore never told the board of the information he had acquired that might have influenced their decisions in February, 1980. Thereafter, in November, 1980, when the board voted "officially" to buy the plant, Creekmore raised no demur. He never suggested that White share the losses in any way. His silence can certainly be seen as having been "in aid of" his client, Jack White. Finally, in December, 1980, the lawsuit essentially "fixed the terms" of the transaction: White formally transferred his shares; the Co-op effectually released White on his guarantee and also paid White's note of \$250,000 to Citizens Bank. Creekmore was, at the time, a director of the Citizens

Bank of Van Buren, an enterprise which stood to profit from the arrangement by having its loan fully paid.

The court feels that there is sufficient evidence upon which a reasonable jury might find, clearly and convincingly, that Carl Creekmore actually defrauded the Farmers Co-op, for the benefit of Jack White and possibly the Citizens Bank, of which he was a director. Where fraud is pleaded against a fiduciary such as an attorney, the rule relaxing the statute of limitations is often invoked to excuse one's failure to discover the facts constituting the fraud. The decree was taken December 19, 1980, and can therefore be said to be the "last act" in a fraudulent scheme spanning nearly a year. The court cannot say that as a matter of fact or law the circumstances of the fraud should have been discovered within two

months. Creekmore has cited us to no event or circumstance occurring between December 19, 1980, and February 23, 1981, which would have put the board on notice that it should have scrutinized his dealings with the Co-op more closely. In the absence of such a circumstance, it would be plainly arbitrary for the court to hold, as a matter of summary judgment, that the alleged fraud should have been discovered within 66 days of its completion.

The court will, therefore, deny Creekmore's motion to summary judgment on the common law fraud claims brought against him by the trustee.

B. THE MOTION OF ATTORNEYS BALL, MOURTON & ADAMS

E. J. Ball and Ken Mourton, (as well as their then-associate and current

partner, Steve Adams,) have asked for summary judgment on Count II, which charges them with fraud, negligence, and conspiracy to commit fraud with respect to the transfer of the gasohol plant to the Co-op. It appears that Ball and Mourton were hired by the Co-op, via Jack White, in May, 1977, to represent it in a civil and criminal tax investigation which the IRS had commenced. On September 5, 1980, the Grand Jury charged Jack White with filing a false tax return (2 counts) and conspiracy to file a false tax return (1 count). In the body of the indictment, the Grand Jury asserted that White had been guilty of self-dealing with the Co-op, and that White and Kuykendall conspired to conceal this fact from the IRS. We have had previous occasion, in the discussion of Count I, to suggest that a reasonable juror could find that this

allegation was capable of putting one on notice that White's loyalty to the Co-op was suspect, and that the interests of the Co-op and its fiduciary White were potentially in conflict, at least with respect to matters raised by the indictment.

On November 12, 1980, Ken Mourton appeared at a meeting of the Co-op board to discuss with them his firm's preliminary findings and recommendations regarding the Government's civil claim for over a million dollars in back taxes. His report was lengthy, taking until lunch to conclude. Mourton left the meeting at this point. When the meeting reconvened, Jack White told the directors that Mourton had advised him that they needed to document their transactions better, and specifically referred them to an alleged earlier determination to buy the gasohol

plant from him, a decision which was not reflected in the minutes, or recorded in any other document such as a deed or contract. The board then voted "to buy the gasohol plan." (Ex. 1528) In many respects, this construction of the evidence is the one most favorable to Ball and Mourton, since it suggests that the Co-op board had actually voted at some time before November, 1980, to buy the gasohol plant, a matter highly disputed in this case. The minutes reflect only that the board "voted to buy the gasohol plant." No terms were set, nor was anyone directed to compose any documents of sale setting forth the terms and conditions of the purchase.

A reasonable jury could find that in February, 1980, the board "talked about" acquiring all of White's interest in the plan, but that the motion was

tabled at White's suggestion. The plant had not commenced production at that point, and held at least a promise of profitability. If it were able to produce at or near capacity (9,000 gallons a day), White stood to make a considerable profit on his investment. White may therefore have suggested that the question be held in abeyance so that he could monitor the plant's production and thereby "play the odds," dumping the plant on the Co-op if it couldn't make a profit, negotiating a lucrative sale to the Co-op if it made money.

One reviewing the record is struck by the ambiguity of the Co-op's relationship to an investment as large as a gasohol plant. Apparently, such ambiguities characterized the way White and the Co-op did business. One of the thirty-four "overt acts" specified in the

indictment charged that White had participated in a venture with a local produce broker named Gunn, and that the two used Co-op facilities. The entity, called Gunn-White Produce paid "rent" to the Co-op, which ordinarily would be fully taxable, being otherwise disqualified from a characterization as patronage-sourced income. White claimed at his trial that he really "represented the Co-op" in the transaction, although there was no documentation for the assertion, and all available documentation (Gunn-White checks marked "rent") pointed to the contrary. This parallel was appreciated by Mourton, who testified in a deposition that when he heard in November that the Co-op had supposedly bought Jack White out in February, he thought to himself that it sounded a lot like the Gunn-White transaction.

There appears to be little support for a finding that the Co-op owned the plant as of February 15, 1980. The earliest indication that the Co-op had indeed bought the plant appears in the November, 1980, minutes. These minutes were absent from the Co-op's record books for several years. It appears that the handwritten originals of all the corporate minutes were collected by Ball and Mourton in preparation for the trial, including the November minutes which had not been typed by the Co-op staff. Undoubtedly, they were kept by mistake, under the impression that the typed copies were at the Co-op available for inspection. In any event, documentation which would have alerted an auditor to "re-check" the Chancery Court lawsuit was absent from the Co-op, and the significance of that

absence and its bearing on the suit is a matter of argument.

On November 25, White asked to have a meeting with E.J. Ball to discuss some Co-op business. He explained to Ball, who may have been unaware of the November 12th vote, that the Co-op lacked documentation for its ownership of the gasohol plant. White wanted to know what method could be used to certify the Co-op's ownership of the plant. Ball suggested that a declaratory judgment action could be filed reciting White's agreement to transfer the shares, and his failure to do so, praying for a judicial declaration that he was obliged to transfer the shares, and had been as of February 15, 1980.

Were the proof to have concluded at this point, we should have little hesitance in deeming it inadequate to

prove actual fraud, although an inference of negligence could be drawn, because of Ball's failure to investigate an unrecorded decision to buy from White a \$4 million "White Elephant." Even a minimal investigation would have revealed that the Co-op was not bound to bail White out. After the meeting, Hardin sent Ball a draft of a complaint he had prepared which "got everything wrong": the date, the terms, the pay-out, everything. Ball answered interrogatories admitting that he redrafted the complaint. The redrafted complaint has substantially different terms, and is significantly more advantageous to White giving him, outright, \$250,000 in benefits which, in the first draft, were contingent on profitable operation of the facility. Ball now denies having amended the complaint. His interrogatories, however,

were signed even if not notarized, and are therefore admissible evidence as a statement by a party opponent. Federal Rules of Evidence, Rule 801(d)(2).

Plaintiffs argue that baneful and fraudulent motives abound for Ball's actions; Ball insists that he was just trying to be helpful. The court is struck by how closely, in many ways, this situation resembles one which unfolded seven decades earlier in the career of Justice Brandeis, when he was a practicing attorney. A party came to him for advice and apparently did not realize that Brandeis' firm represented an interest antagonistic to his. Brandeis counseled him to pursue a course of conduct which the client later had second thoughts about, and wanted to rescind. He leveled charges of fraud against Brandeis, who denied that he did anything more than

counsel the individual how best to effectuate the dissolution of his business and the payment of his creditors. The individual's new lawyer had decided that an assignment for creditors was not such a good idea, and challenged Brandeis to reveal just whose interests he thought he was protecting when he gave the initial advice. Brandeis replied: "I should say that I was counsel for the situation."

Hearings Before the Subcommittee of the Senate Committee on the Judiciary on the Nomination of Louis D. Brandeis to Be an Associate Justice of the Supreme Court of the United States, 64th Cong., 1st Sess., sec. 6926, at 287 (1916).

It is perfectly inferrable that Ball, in the unfortunate but apt phrase of Brandeis, was "counsel for the situation," suggesting an expedient, problem-solving procedure for accomplishing what everybody

seemed to want. Such a voluntary service may not be negligent, although, once undertaken it must be pursued in a diligent, careful, and conscientious manner, particularly where the service was, as here, fully compensated by the Co-op. Such a duty may require minimal investigation, particularly where White's dealings with the Co-op appear to have been conducted at less than arm's length.

Lack of care may also be inferred from the fact that one who counsels corporations and their fiduciaries have to be on the alert whenever there is traffic between the two. To be frank, there appears to be a unanimity of opinion that Jack White was essentially unchecked by anybody at the Co-op: what he said, the Co-op did, and board meetings and resolutions were mere formalities along the way. The Arthur Young accountants

realized this: they commented on it in their work papers. (Exhibit 855). A jury may conclude that White, who was at least suspected of fraudulent activity vis a vis the Co-op, made what should have been a surprising suggestion to Ball who, rather than investigate its bona fides, blindly facilitated the perfection of a transaction which dearly cost his other client, the Co-op. Even though we as a society strive to accord to all our citizens the right to be presumed innocent until proven guilty, there are limits to the application of that doctrine. A reasonable jury could well conclude that in any transaction involving White and the Co-op, after the indictment, red flags abounded to those who wanted to see them.

The jury may further conclude that the conduct of Ball and Mourton was reckless, which, in the context of

fiduciary relationships, is all that plaintiffs need to show to submit a claim of fraud to the jury. After the November 25 meeting, Ken Mourton went to Kansas City and conferred with specialists in co-operative taxation and accounting about the "tax advantages" for the Co-op if the transfer could be established as having occurred on or before the date when the plant commenced commercial production. It appears that there were none. Morton apparently told Ball that this was the case in a telephone call from Kansas City. The reason for establishing an early date for the acquisition of White Flame Fuels by the Co-op had disappeared for all but one party; Jack White, who stood to improve his personal balance sheet considerably if he had documentation to support his non-involvement with the plant. For one thing, his \$4 million debt

to the Co-op would disappear. Second, if the lawsuit were properly worded, the Co-op stood to relieve him of obligations to pay hundreds of thousands of dollars of loans to local banks. If, indeed, there was any other motive than to benefit Jack White by going ahead with the "friendly lawsuit," the court cannot find it. The lawsuit was plainly inadvisable absent that circumstance. Why, a jury may inquire, would a criminal defense attorney subject his client to news stories which would report that his client had "been sued" by the Co-op three weeks before trial started in a case involving his client's course of dealings with the Co-op?

On December 9, 1980, apparently aware that there was no real rush to document the transfer of the plant to the Co-op, Ball took the redrafted complaint,

answer, and decree to Creekmore for filing and execution. The evidence would freely permit a reasonable juror to conclude that the transaction was designed solely to benefit White -- or at least that on balance the financial benefits to be gained by him outweighed, in White's mind, the possibly ephemeral effects of bad publicity on the eve of his trial. If the transaction were that advantageous to White, one who represented the Co-op's interests would have had to have wondered why it was such a good idea for the Co-op.

Situations such as these are sometimes the unfortunate fallout from acting as "counsel to the situation." Unless one really has a client, one really has no interests to protect, and no real curiosity about the matter. That can be non-negligent, of course; or it can be

negligent, reckless, constructively fraudulent or actually fraudulent. The court cannot decide the issue on defendants' motion for summary judgment. In plain words, there is ample evidence rationally to sustain any one of the possible conclusions. This is especially so where one finds that a "sweet deal" was made even sweeter for White by the re-drafted complaint, a circumstance for which there is no compelling explanation.

Furthermore, plaintiffs' expert witness, Drew Kershen, has testified that Ball and Mourton were representing conflicting interests. This opinion alone, if not unreasonable, would raise a fact issue incapable of resolution by summary judgment. Generally speaking, an attorney may be liable to his client for losses resulting from the representation of adverse interests. Rolfstud, Winkjer

et al. v. Hanson, 221 NW 2d 734 (1974). An attorney who, even with the consent of the interested parties, represents such adverse interests may be liable for loss sustained by one of them due to the attorney's failure to disclose a material fact. Johnson v. Andrade, 54 S.W. 2d 1029 (Tex. 1932). The jury may conclude that a cursory inquiry by Ball and Mourton would have revealed to them that the Co-op could lawfully disaffirm whatever ambiguous relationship existed between it and the gasohol plant. In such a circumstance, the Co-op might have wanted to investigate anew whether it was a good economic idea to buy the plant at a price which guaranteed White no losses. "Partners" share losses, unless one doesn't watch out. Nothing could have been easier than to have called a special meeting of the

board to ventilate all the considerations so important to such a critical decision.

The court would make it clear that this question is not one resolvable solely by reference to the Canons of Ethics. The basis for this civil action is the common law of fiduciary obligations. Fielding v. Brebbia, 399 F.2d 1003, 1005 (D.C. Cir., 1968). Whether or not a breach of that obligation has occurred may be determined by reference to the standards set forth in the Disciplinary Rules. Jeffry v. Pounds, 67 Cal. App. 3d 6 (1977). We interpose this distinction in response to defendants' suggestion that the court make a ruling on the merits since the simultaneous representation of White and the Co-op was not in contravention of the Cannons [sic]. (Defendants' Reply, Part IV A). Their authority, American-Canadian Oil & Drilling Corp v. Aldredge & Stroud,

237 Ark. 407, 373 S.W.S2d 148 (1963) does not hold, as defendants suggest, that where the questions for decision implicates the Canons, there is never a question for a jury to decide. That would be an odd holding to announce in the context of an appeal from Chancery Court. American-Canadian's reference to such questions as being "ones of law" means only that the Canons do not absolutely exclude the possibility that a lawyer might ethically represent parties with nominally opposing interests. If that were the case, Aldredge and Stroud would have had to have surrendered their fee with no further inquiry. The court said, however that "[t]he primary question for determination is whether the attorneys did, either in fact or as a matter of law, represent conflicting interests...."Id., at 409. Inasmuch as Aldredge and Stroud's

representation was not excluded as a matter of law, the court then made a factual inquiry to determine whether, in fact, the interests were in conflict. The decision recognized that the existence of a conflict is primarily a factual question. In this case the inferences to be drawn from the facts are competing and far from clear.

An attorney may represent two parties where "it is obvious" that their interests do not conflict. A jury may decide that it was not at all "obvious" that the interests of White and the Co-op were in harmony. They may then proceed along further avenues of inquiry. The Code does not indicate how "clear" a conflict must be in order for dual representation to be impermissible. The court infers from this that the community, as embodied by the jury, has a role in

deciding such questions, bringing to bear their own experiences in life.

This inquiry, as we have suggested, may support a finding that Ball and Mourton were reckless. This permits an inference of fraud: as a matter of law, in fiduciary contexts, where a finding of recklessness may be made, a question of fraud has to be submitted to the jury. A finding of actual fraud by the jury would render moot any reliance on the formalistic propriety of the activities in question under the Canons of Ethics.

A finding of fraud based on evidence of recklessness would also permit the jury to conclude that the defendants conspired with others to damage the Co-op. Moody, in his motion for summary judgment, correctly pointed out that one cannot recklessly join a conspiracy. We

hold that to be undoubtedly true. Recklessness in a fiduciary relationship permits but does not require a finding of fraud. The jury may find recklessness and decline to find fraud. Fraud is a matter of positive intent, a subjective and interior mental attitude rarely capable of direct proof. Permitting the inference to be made on evidence which, in a non-fiduciary context, would not otherwise suffice, simply recognizes the distinctiveness and the importance of the context. Collaterally, it has the effect of reinforcing the fiduciary's duty to handle his ward's affairs with care. Simply stated, the law demands more of fiduciaries.

If the jury makes the permissible leap from recklessness to fraud, there is no impediment against their finding a conspiracy to effect it. The parties to

this transaction worked quickly and in coordinated fashion, pursuant to an agreement. In this case, the "agreement" to formally document the transfer of the gasohol plant to the Co-op by concerted action exists and is admitted by all. The argument is whether the agreement was intended for ill or not. There can be no question but that Ball advised the procedure, and that Creekmore consented to effectuate it. Depending on their intent, the agreement was either innocently, negligently, recklessly, or fraudulently made. Either of the latter two findings will permit the jury to conclude that the suit was the product of a civilly actionable conspiracy. It is not necessary that a civil conspiracy be proved by direct evidence. "That some links in the chain of conspiracy. . . .to defraud have been forged from

circumstantial evidence, and in the fact of a flat denial thereof by one of the defendants, does not weaken the finding of the jury." Johnston v. Andrade, supra, at 1030. In most cases, conspiracy counts are dismissed because of an absence of evidence that parties acted pursuant to an agreement. Here an agreement of some kind is admitted. We therefore believe that plaintiffs may submit this case to the jury against Ball and Mourton individually, as joint tortfeasors, and as conspirators.

In conclusion, summary judgment will be denied Ball and Mourton on their motion in opposition to Count II of the Consolidated Complaint. As we have stated in response to Creekmore's motion, the fact that more than three years passed since the conclusion of the alleged fraud in transferring the gasohol plant to the

Co-op does not necessarily absolve them by a plea of limitations, since a more relaxed rule is involved in cases wherein fiduciaries are said to have defrauded their wards. The defendants will be permitted, evidence allowing, to submit instructions asking that the jury consider the limitations defense, the defense of ratification, or any other matter upon which the evidence permits a finding. It would be plainly arbitrary for the court to declare that the White-dominated Co-op Board should have discovered the alleged fraud within sixty-six days of its completion, or that any Co-op shareholder should have discovered the "true" state of affairs and commenced a derivative action.

A more vexing question is presented with respect to the negligence claims against Ball and Mourton, or for findings of recklessness in the absence of

fraud. A single consideration prevents our granting summary judgment on those claims. The Arthur Young auditors sought information about White Flame and sent a letter to Ball and Mourton, asking for data relevant to their audit. Mourton responded, saying that the only thing Ball and Mourton knew about White Flame Fuels, Inc. was that it was being audited for 1980.

Creekmore, as we have said, did nothing after his term of employment with the Co-op that concealed in any way any possible negligence on his part. We are furthermore of the opinion that one loses his right to the repose promised by the statute only where he fraudulently and knowingly conceals his former negligence. We are frankly hesitant to permit the plaintiffs to proceed on a theory of negligence or mere recklessness against

Ball and Mourton, but are not satisfied on the state of this record to grant the summary judgment. For one thing, the letter was, in a sense, untrue: Ball and Mourton did know that White Flame was allegedly purchased by the Co-op in February, 1980, a fact which, if given to the auditors, would cause a number of problems, if only for Arthur Young. Furthermore, Mourton in his affidavit did not explain the letter, and Ball's affidavit refers to (but does not produce) a letter from White which would otherwise put Mourton's response in context. Because it is possible, in a fiduciary context, for a failure to disclose to be fraudulent, Mourton's letter may not have "disclosed enough" to survive a plea of tolling on a motion for summary judgment. The court may be willing, at the conclusion of the evidence, to take this

question from the jury, but frankly hesitates to do so now, in the absence of a firmer conviction, supported by the record.

Finally, Steve Adams' motion for summary judgment is granted, not only as to this count, but as to all others. His liability for the acts of Ball and Mourton extends only to his interests in the partnership, except for those damages legally chargeable to the firm after January 1, 1992.

IV. COUNT III: SECURITIES FRAUD IN TRANSFERRING WHITE FLAME STOCK TO THE CO-OP

The Consolidated Complaint charges Ball and Mourton, and Carl Creekmere, with securities fraud in connection with the transfer of the shares of White Flame Fuel to the Co-op. As we mentioned in our opinion on the motions to dismiss,

Robertson v. White, 634 F.Supp., at 969, this cause of action may be pursued only by the "buyer", i.e., the Co-op.

Ball and Mourton argue that the state securities law complaint should be dismissed as to them because they were not "controlling persons" under the statute; because they had no knowledge of any untruth or omission with regard to the transfer; and because they did not materially aid the transfer, or otherwise act recklessly. (Ball and Mourton, Motion for Summary Judgment, Brief, p. 32).

Ball and Mourton argue that it is undisputed that the transfer of the gasohol plant happened before the November 25th meeting with White during which they merely suggested a way by which the transaction might properly be memorialized and documented as having occurred on February 15. Consequently,

they suggest there can be no securities fraud chargeable to them because the transaction was final for all intents and purposes before they did anything. Their function, the argument goes, was merely clerical, and if vulnerable to attack for that reason, could only be redressed under common law counts for negligence and fraud, whose elements and damages differ from those permitted under the Arkansas Securities Law.

First, as the court has had occasion to observe, in connection with our opinion denying plaintiffs leave to amend their complaint, Robertson v. White, CIV-86-2044 (W.D. Ark. slip op May 16, 1986) it is extremely doubtful that a jury would find that Jack White parted with his interest in the gasohol plant on February 15. He continued to make sworn representations to all and sundry that he

owned the plant. In any event, the evidence on that point is such that a reasonable jury could find indeed that no decision had been made by the Co-op board to buy the plant.

Second, as we have observed, the minutes of the November 12 board meeting say only that the board voted to buy the gasohol plant. No terms were specified, and a jury can find that no contractual obligation existed which bound the Co-op to do anything at all. Furthermore, the minutes reflect that the Co-op board voted to buy the plant, not the stock of White Flame Fuels, Inc. One can buy all of a corporation's assets, and none of its stock, and thereby avoid securities laws problems. As Mr. Justice Stevens dissenting in Landreth Timber Co. v. Landreth, 53 LW 4620, 4607 (1985) said "[i]t is only a matter of interest to the

parties whether the transaction takes the form of a sale of stock or a sale of assets," a circumstance from which he argued that the Federal securities law should not apply to sales of a business involving transfers of stock. In Justice Stevens' mind, securities questions could be avoided entirely by a contractual provision in which the buyer would elect to buy all the assets of a corporation, and none of its stock. The court majority, however, applied the "plain language" of the federal securities statute, which by its own terms governs the sale of "any security," including "stock."

Under this analysis, it may very well be that it was Ball and Mourton alone who were responsible for introducing "securities issues" into the situation. It is very doubtful, viewing the record in

the light most favorable to the moving party, that a jury would find that the Co-op board had voted to buy White Flame's stock. We do not therefore accept the suggestion that a securities transaction had been completed before November 15, 1980, even if the Co-op were contractually bound to "buy the plant," a matter which is highly disputed.

Defendants also suggest that Ball and Mourton were not controlling parties of Jack White, and were not employees of White Flame who "materially aided" the sale of the security. An attorney for a seller of securities can be considered a controlling party if he assists in preparing circulars or opinion letters containing incorrect information. SEC v. Frank, 388 F. 2d 486 (2nd Cir. 1968); SEC v. Spectrum Ltd., 489 F. 2d 535 (2nd Cir. 1973); Felts v. National Accounting

Systems Associates, Inc., 469 F. Supp. 54 (N.D. Miss. 1978). Such a level of assistance is not materially distinguishable from that alleged to be present in this case, i.e., preparing all the documents for the transaction, and designing it in a way so as to implicate the securities laws.

In addition, the state securities act enumerates the parties against whom purchasers may prosecute an action. The law does not purport to say that such parties are the only ones who could be responsible under the law, since such a limitation would conflict with its broadly remedial purpose. Indeed, Ark. Stat. Ann. §67-1256(h) asserts that the rights granted under the law are in addition to others which exist in law in equity. Rights against joint tortfeasors are established by law, and extend beyond the

principal actor to embrace parties who advise or encourage him to commit a particular act, see generally, Lewis v. Mays, 208 Ark. 382, 186 S.W. 2d 178 (1945), or those who, having a duty to speak out, remain silent. We believe that a reasonable jury could conclude that Ball and Mourton are liable under both statutory and common law theories. Defendants also argue that they have established the good faith defense set forth in Ark. Stat. Ann §67-1256(b). The court believes that a jury question has been made out on that issue, as well.

The lawyer defendants also protest the legal sufficiency of actions brought against them under the Federal securities laws. They argue in this connection that since they did not sell the White Flame securities, their liability is limited to "aider and abetter" liability, which

requires the existence of a primary violator (e.g., White), knowledge of his violation, and substantial assistance. For reasons discussed generally before, the evidence will permit an inference that Ball and Mourton owed a duty to the Co-op as its own lawyers in the transfer of White Flame shares to it. Although the proper delineations of who represented whom are lost in the murky depths in which one sometimes finds himself when he undertakes "to counsel a situation," plaintiffs argue that at his deposition Mourton said he believed that the firm was representing the Co-op: If that was the case, the firm owed duties to the Co-op relative to the transfer, even though such duties were otherwise beyond the original scope of their representation.

As we have mentioned, a jury may infer recklessness, given that Ball and

Mourton gave credence to parties who could not document a highly questionable assertion, and who appeared to be ready to accomplish their goal by a means which Mr. Ball thought clearly fraudulent (backdating the stock). One of the parties at the meeting (White) stood accused of self-dealing; another (Brewer, Chairman at the Co-op board) was an unindicted co-conspirator; and the third, Creekmore, was absent from the February 15 meeting at which the deal was allegedly struck, and was in no position to confirm or deny details. Ball and Mourton cannot claim that Creekmore clearly misled them at that time, at least for purposes of summary judgment, since Creekmore denies being present at the November 25th meeting. This is all a very long way of saying that this matter cannot be concluded on summary judgment. The court

declines to repeat, again, all the facts and circumstances from which a jury can infer recklessness, or fraud. Suffice it to say that plaintiffs have made a jury question on scienter.

The court believes, also, that plaintiffs have proved substantial assistance. Defendants admit counselling the means by which the transfer would take place, supervising the preparation of the documents, and delivering them for ultimate approval by the Court, as well as counselling that the interests to be transferred be specified as securities. It appears on the face of the record, from defendants' admissions, that their input was the sine qua non of a securities transaction, and the only real question appears to be scienter, which as we say is subject to conflicting inferences.

That which we have asserted with respect to Ball and Mourton's motion applies as well to Creekmore's. The inference of scienter is much stronger in his case, since he presumably knew, far in advance, that the gasohol plant was an unwise investment, and concealed that fact from the Co-op, suppressing the bond offering statement which was intended to have been read by the directors before approving an investment in the plant. If that information was relevant for a decision to buy bonds, it was relevant for a decision to buy stocks. Furthermore, Creekmore substantially assisted the transfer by acting as Co-op counsel in the suit, and procuring the decree. His motion for summary judgment on Count III will also be denied.

We believe, therefore, that plaintiffs may present to the jury a claim

for securities fraud and conspiracy against Ball and Mourton, and Carl Creekmore, in connection with the December 19, 1980, transfer of shares in White Flame Fuels, Inc., to the Farmer's Co-op. Inasmuch as the statute of limitations under the state and federal acts is five (5) years, questions on that defense will not be submitted to the jury.

V. COUNT IV: NEGLIGENCE AND /FRAUD  
IN ALLOWING THE CO-OP TO CONTINUE  
IN OPERATION AFTER INSOLVENCY

Count IV survived motions to dismiss directed against both the class and the trustee. At the time of our rulings on the motions to dismiss, the contours of the rights severally asserted by the Co-op trustee, and by the class, were not known. Now that the record is clearer, the court can proceed to

adjudicate the motions directed against these causes of action. The court alleges that the directors, lawyers, and accountants wrongfully prolonged the operation of the Co-op, deepening its insolvency, and rendering its creditors less secure. The complaint asserts that this cause of action is based on one filed by the Superintendent of Insurance in Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983). That action, in its turn, found its moorings in Illinois corporate law, and statutory law governing insurance companies. Id., at 1345.

The common law of Arkansas does not recognize a separate tort of "managing an insolvent corporation." We believe, in fact, that very few jurisdictions hold to such a view any longer. Some jurisdictions early on held that it was prima facie fraudulent for a director of

an insolvent corporation, knowing its true condition, to accept an extension of credit, see Cassidy v. Uhlmann, 170 N.Y. 505, 63 N.E. 554 (1902). Such views were not uniformly held in America, see e.g., United States Fidelity and Guaranty Co. v. Corning State Sav. Bank, 154 Iowa 588, 132 N.W. 857 (1912). The Cassidy court reasoned that when, by virtue of fraud or during insolvency, a corporation accepted credit from another party, the ordinary relation of debtor and creditor did not arise. Instead the directors of the corporation became trustees ex maleficio for the creditor because "title" to the money never passed. Cassidy declared, in effect, that the relation of trustee and cestui que trust came into existence, giving creditors direct rights of action against the directors of insolvent corporations, as more than one such

officer, including Uhlmann, discovered in the aftermath of the Depression of 1893.

Such views as Cassidy's are decidedly antique. Nineteenth century courts were not always friendly to the corporate fiction, and the political atmosphere of the Populist era, particularly as it expressed itself in legislation, did little to ease that hostility. In Arkansas, for example, corporations were required to file annual financial reports in the courthouse. If they did not, directors became personally liable for all corporate debts even in the absence of reliance or misrepresentation. Kirby's Digest of 1904 §848. See, e.g. Hughes v. Kelley Bros., 95 Ark. 327, 129 S.W. 784 (1910). - See also, "The Wingo Act," Ark. Stat. Ann. §64-1202 (1980 Repl.)

As the corporate form and the society within which it existed matured, restrictive policies disappeared, and a more neutral view of incorporated entities became prevalent. In 1965, Arkansas passed its variant of the Model Business Corporation Act, a compendium of statutes more liberally inclined towards management than the codes which had preceded it. The Act is this state's organic law of corporations, and governs the relations among the various interests implicated in a corporation - officers, directors, shareholders, and to some small extent creditors.

We believe, upon review the Act, that it repudiates the kind of analysis which made the continuing management of an insolvent corporation tortious per se against creditors and investors. For example, whereas older courts may have

made directors "trustees" for creditors, the Arkansas Act says: "the directors of a dissolved corporation should not be deemed to be trustees of its assets. . . ." Ark. Stat. Ann. §64-904(A)(i). While this section of the Act ought not be interpreted expansively, we believe that it is at least expressive of a notion that corporate directors are not to be considered fiduciaries for "the world," a view towards which older cases such as Jackson v. Lockling, 88 U.S. 616, 624 (1874) inclined. If directors are not to be deemed trustees when a corporation is in liquidation, a process not always supervised by a court, there seems to be little support for a notion that the Arkansas common law would impose a trust on them while the business was still conducting its affairs, even though insolvent.

This is not to say that directors or third party professionals owe no duties to the shareholders or to that part of "the world" which extends business credit to a corporation. Rather, the duties owed exist independently at common law - i.e., the duty not to be negligent, not to be fraudulent - and knowledge of insolvency is only a factor to be considered in determining the scope of the duty and the extent of the liability.

For example, in Shapiro v. Glekel, 380 F.Supp. 1053 (S.D.N.Y. 1974) a bankruptcy trustee brought an action against an accounting firm which had formerly been employed to audit a company's books. The trustee charged that the accountants had negligently failed to detect inaccuracies in certain financial statements, and that the corporation was thereby allowed to overstate its earnings

and financial condition, leading the directors to engage in an ill-advised series of acquisitions. The trustee claimed that the accountant's errors caused the firm to declare bankruptcy. Significantly, the accountant defendants claimed that the top officers of the company knew that the statements were inaccurate, which, they argued, should have estopped the trustee from asserting the auditors' errors as cause for damage; the defendants also argued that the corporate entity was, on the evidence, contributorily negligent as a matter of law. Such a finding, in New York law at the time would have barred recovery.

Shapiro held that the correct rule for contributory negligence applicable in accountant's liability cases is that the negligence of the employer is a defense only when it has contributed to the

accountant's failure to perform his duties and to report the truth. Id., at 1058. We believe that to be the correct statement of the law. While it is true that a director's knowledge may be imputed to the corporation, that rule does not apply where the director, or agent, is acting contrary to his master's interest, or in pursuit of his own. In the context where a professional auditor is retained, a law which would shield an auditor from liability in such cases would hardly encourage accountants and auditors to determine the most accurate and reliable data. The auditor's role in our society would be effectively undermined if he suffered no liabilities to his client for a negligent assay of financial statements because the knowledge of "a director" forecloses recovery. A duty to report truly and carefully should be enforced

against auditors if for no other reason than that, on the least chance, there might exist one member of a board who cared or who took his duties seriously.

It hardly speaks well of a profession that it can take a fee from an enterprise managed by persons whom it knows to be unsophisticated ("Farmer's Co-op's Board of Directors and Management Team: Do they have the capability to keep the Co-op afloat? Fred Howard - Yes. The directors - you know them, what do you think? AY work papers, No. 11405 [emphasis added]) and perhaps even insouciant, and that it can defend its own negligent performance because it suggests that the directors knew that the unstated problems existed. That appears to be Arthur Young's defense. (Memorandum, August 14, 1986, pp. 9-11).

We believe that a reasonable jury could find that under the particular circumstances of this case Arthur Young's performance was negligent. Some of these circumstances are: (1) the presence of a multi-million dollar enterprise, receiving investment capital exceeding \$10 million; (2) management so naive as to be the subject of deprecatory comment in the auditors' work papers; (3) a financial situation sufficiently precarious as to earn the professional sobriquet "Close Monitoring Client"; (4) a history of "related party transactions" so outrageously extreme that the principal beneficiary of Co-op "gifts," Jack White, is emboldened to demand \$82,500 from the co-operative as recompense for a "contribution" he admittedly made many years ago (AY 11513); (5) the presence of a "nonproducing asset", in the form of a

gasohol plant, the very existence of which is an albatross around the Co-op's neck, and the acquisition of which was just one of a series of "related party transactions" which seemed, for some reason, solely and consistently to benefit one person. In these circumstances, the "auditors" had the choice of writing down the gasohol plant to its net realizable value, and really getting people's attention, or maintaining and even to a certain extent inventing a fiction that the plant belonged to the Co-op since 1979! This "hypothesis" allowed the auditors to carry the asset on the books at its cost, \$4.5 million, rather than its worth, perhaps \$750,000, and therefore gave the Co-op the appearance of solvency. In September, 1982, four months after this artificially roseate audit was presented, the Co-op board, not having had their

attention aroused, entered a contract with Jack White to operate the gasohol plant, promising him "half the profits." Mr. White was astute enough not to make a profit from the operation of "White Flame Fuels." He sold the grain used to make gasohol, at a loss, to his new business, Valley Feeds. Valley Feeds sold the grain at a profit.

The court believes, under the rule of Shapiro v. Glekel, supra, that a reasonable jury would be justified in finding that the Arthur Young accountants did not proceed through their engagement as reasonable men would do. They would be entitled to find that certain damages were proximately caused by their lack of care. Id., at 1058-59.

In short, although we do not believe that the operation of a business during its insolvency is per se negligent

or wrongful, we believe that insolvency and its perception is a very important circumstance to keep in mind when one gauges the duties owed by an auditor to his client. It is a sign that says "thin ice." It will ultimately be for the jury to decide whether the auditors behaved reasonably, in light of all the circumstances.

Context is also important in determining whether the auditors behaved recklessly. As we have said with respect to the attorneys, lawsuits do not rise or fall on the question whether a given ethical canon was observed or violated. Those canons are guides for the jury in making ultimate determinations. Similarly, auditing standards and accounting principles are helpful to a jury in determining whether the accountants comported themselves as

reasonably competent professionals or whether they departed grossly from that standard. A finding of actual fraud by the jury renders an arguable compliance with standards moot; a good faith compliance with the standards, however, makes a finding of fault impossible.

In reviewing the motions for summary judgment, the court believes that a jury might reasonably find that Arthur Young's audit report was dictated by the result it wished to achieve, for whatever reason. Plaintiffs have suggested that the accountants did not want a reputation for being too punctilious, or wanted to keep the Co-op's business, or maybe wanted to cover themselves for having testified on behalf of White and Kuykendall in the 1981 criminal trial. The court is uninterested in motive, except to suggest that plausible ones have been advanced.

The record may permit a reasonable jury to find that the auditors adopted a blatant fiction - that the Co-op owned the entire plant at its inception in May, 1979 - in order to justify carrying the asset on its books at its total cost, as if the Co-op had built it from scratch. The auditors indulged this fiction despite being aware of the Chancery Court decree which said that it assumed ownership of the plant in February, 1980, at a time when it was substantially completed. The auditors also had reviewed contracts and other documents showing that Jack White and Edwin Dooley jointly started the plant in May, 1979, and that White bought Dooley out six months later, taking an assignment of all of Dooley's stock. An investigation would have revealed to them that the minutes of the February 15, 1980, meeting of the Co-op board, during which

the \$4 million plant was allegedly "purchased," were completely silent on the point. Furthermore, audits for 1979 would never have shown that the Co-op owned the asset or claimed to have had any interest in it. A reasonable jury could conclude that the Arthur Young defendants picked an acquisition date out of the air that they could "justify," in order to record assets onto the books in a way that would make White's management "look better."

A reasonable jury could find from the evidence that when this decision was made, the cost figure given the asset was essentially invented. The Arthur Young accountants have testified that they "independently" arrived at a figure for the "cost of the gasohol plant that matched, to the penney, the figure assigned by convicted felon Gene Kuykendall in his audit for White Flame.

Fuels. If Mr. Kuykendall had audited White Flame for 1980 in accordance with generally accepted accounting procedures and auditing standards, such a congruity of result in a similarly conducted "independent" review would not be remarkable. However Kuykendall testified in a later deposition that he essentially "got up" a figure for White Flame overnight a few months after his conviction. He took all the moneys spent on the plant, and arbitrarily capitalized 80% of these and expensed the rest. Not only that, Kuykendall, realizing that snooping revenue agents might become suspicious if items were expensed at 20% across the board, cleverly juggled the figures so that certain categories of expenditure were expensed at a rate of 23%, others at 18% or 19%. He candidly admitted that expenses were figured at

20%, because otherwise the gasohol plant would have shown "a tremendous big loss" for 1980. That would not have been very pleasant for his friend, Jack White, who hung the albatross around the Co-op's neck at the end of that year.

A reasonable jury would be justified in concluding that Arthur Young did not independently arrive at Kuykendall's figure, and that the odds against their having done so were astronomical. A reasonable jury could find that Arthur Young had no actual belief in its audit report: either in the cost figure at which to record the gasohol plant or in the fiction which they employed to justify carrying the asset at cost. A reasonable jury could conclude that the determination to carry the asset at cost rather than value was critical to the presentation of the Co-op as "a going

concern." A reasonable jury could conclude that a determination not to write the plant down to its "net realizable value" effectively delayed the reorganization of the Co-op for two years, and that furthermore this was a foreseeable consequence of that decision. A reasonable jury could conclude, under the authority of Shapiro v. Glekel, supra, that this decision proximately resulted in damages to the Co-op.

Unlike Shapiro, a jury in this case could reasonably conclude that Arthur Young's conduct was fraudulent. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931) held that an auditor cannot be liable in negligence to one not in privity with him, such liability groundable only in fraud. The court defined fraud for such purposes as follows: "Our holding does not emancipate

accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy. . . ." Id., at \_\_\_\_\_. Later, in State St. Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E. 2d 416 (1938) the same court said: "A representation certified to be true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient on which to [find fraud]." (emphasis added). The court believes, especially given the context in which Arthur Young's services were rendered, that a jury would be amply justified in finding that the accountant's audit report was a fraud on the Co-op Board, whose

members have repeatedly testified that they relied on skilled professionals to give correct and reliable advice.

A finding of fraud would also enable members of the class to protest that they bought notes, or refrained from cashing theirs in, on the reasonable belief that the Co-op was solvent. However, in Arkansas, common law fraud claimants must prove that they specifically relied on a given representation. CF. Higgins v. Hines, 289 Ark. 281, 283-84, 711 S.W.2d 783, 784 (1986). The record does not permit a finding of the specific kind of reliance required by the common law precedents in this state or others. The history of the action of fraud is such that one must show that a given misrepresentation was material, and that it induced the transaction or forbearance complained-of.

In the patois of securities lawyers, fraud plaintiffs must prove "transaction causation" as well as "loss causation."

The common law of fraud has its own logic and policies, and exculpates the unscrupulous who are fortunate enough to con the extraordinarily gullible. That is, if a defendant can prove that his misrepresentation was "too outrageous" for reasonable belief, then he can defeat a common law action. Prosser and Keeton on Torts, 5th Ed., §108, pp. 749-750, citing, H. Hirschberg Optical Co. v. Michaelson, 95 N.W. 461 (Neb. 1901).

The foregoing is set forth to demonstrate the recalcitrance of the common law of fraud and deceit to new theories in which elements such as "reliance" are capable of being presumed. In the common law world, it is still very much dog-eat-dog. We have seen no

inclination from the Arkansas courts that they are willing to abandon fraud's traditional focus on the plaintiff's reasonable reliance in favor of a system of liability which seeks to deter all deceitful conduct.

As we shall have occasion to see, however, the securities laws of the state and federal governments have been drafted with a different purpose in mind, viz. the protection of investors. In a context in which by its very nature one parts with money, to be controlled by another, with the expectation of profit to accrue thereby, the legislatures have shifted their focus so as to encourage full and accurate disclosure of investment information. Capital is a precious resource. Squandered, it is useless. Governments have an interest in seeing to it that legitimate and profitable

businesses do not have to compete on an unfair basis with unscrupulous enterprises for the attraction of capital. Therefore disclosure laws are enacted to redress the competitive imbalance that can exist without redress under the common law. Simply put, a series of rules that emerged out of warranty two centuries ago in the case of Pasley v. Freeman, 100 Eng. Rep. 456 (U.B. 1789) are inappropriate for broadcasts to an extensive investor community whose responses to the same information are bound to vary according to temperament and other individual characteristics. In such a circumstance, it is only sensible, given the policies of the government to encourage a rational allocation of capital resources to shift the focus of a legal inquiry away from the many individual buyers and sellers, and onto the relatively few promoters. This

shift in focus will justify the imposition of liability onto Arthur Young for violation of the securities laws, as we shall see, infra.

Finally, the plaintiffs have charged that there was a giant conspiracy among all or part of the defendants to maintain the Co-op through insolvency. Such a hypothesis "explains" a lot. However, there is no evidence for it. We could at greater length explain our conclusions in this regard; we believe, however, that such examinations are more appropriate in cases where plaintiffs offer some evidence in support of their assertions, or where they inform the court who, of all the defendants, engaged in the conspiracy. Simply stated, the charge of conspiracy lacks any factual support. We do not think it wise to expose late arriving defendants such as Arthur Young

to millions of dollars of pre-existing losses unless there is some evidence to support an inference that Arthur Young, in essence, bought into White's programme of frauds against the Co-op. If there were evidence of such an agreement, we would not hesitate to submit the matter to a jury. We are finally convinced, under the reasoning of Anderson v. Liberty Lobby, Inc., 54 U.S.L.W. 4755 (1986); Mitsushita Electric Industrial Co. v. Zenith Radio Corp., 106 S.Ct. 1348 (1986); and Fidelity Mutual Life Insurance Co. v. Price, 180 Ark. 214 (1929), that no triable issue of conspiracy is presented under this count against any of the defendants.

Furthermore, there appears to be no issue under this count with respect to Ball and Mourton, or Carl Creekmere. The only acts alleged against Ball and Mourton relating to events happening in 1982 are

that they continued representing White through his appeal and sent a single letter to an auditor. We have suggested that the letter may toll the statute with respect to earlier negligence, but we decline to find that it constitutes grounds for an entirely new cause of action. Summary judgment will be entered in favor of the lawyers and accountants on theories of conspiracy, and in favor of the lawyers with respect to allegations of fraud and negligence asserted in connection with the Co-op's operation through and beyond insolvency. Summary judgment is being denied on the Trustee's complaint that the performance of the auditors negligently or fraudulently caused damage to the Co-op.

VI. COUNT VI: ACTIONS UNDER STATE AND  
FEDERAL SECURITIES LAWS CLAIMS

Defendants have moved for summary judgment on the class's state and federal securities law claims. These claims seek to hold the lawyers and the accountants liable for the sale of unregistered securities, as well as for issuing securities by means of fraudulent misrepresentations of the Co-op's financial status. We have reviewed, in our discussion of Count IV, the basic statement with which the plaintiffs take issue: that the Co-op was solvent, when in fact it had a negative net worth and a horrendously low current ratio. The plaintiffs allege further as against the Arthur Young defendants that they permitted employees of the Co-op to "condense" the audit report so as to exclude any of the accountants'

explanatory notes. These notes warned, for example, that there was "some doubt as to the recoverability of the investment in the gasohol plant." It appears to be concededly true that an audit report issued without such a qualification would mislead a reader.

It appears from the record that the Arthur Young accountants met with the Co-op board to discuss their 1981 and 1982 audit reports in the spring of 1982 and 1983. They answered questions from the board, and agreed, for a fee, to address the annual meetings of the shareholders to be held a few weeks later. At these annual meetings, which were widely attended, the Arthur Young accountants were introduced to the membership as the Co-op's auditors. They then reported on the previous years' operations and presented a summary of the Co-op's assets

and liabilities. These summaries did not inform the membership that the gasohol plant was being carried on the books at cost. Instead, the members were told that a complete report was available for inspection "in the office." In addition, the Co-op mailed a monthly newsletter to its membership. This newsletter advertised the attractive rates of interest offered by the Co-op's demand note program and contained balance sheet information primitively styled "What You Own" (Assets) and "What You Owe" (Liabilities).

The information telling the Co-op member "what he owned" included the inflated cost basis report of the gasohol plant. Co-op members were continually reassured that the Co-op's million-dollar equity made investments in the demand note program "safe . . . secure . . . and there

when you need it." In fact, plaintiffs say, the Co-op was deeply insolvent for nearly two years before its bankruptcy.

At the shareholders' meetings themselves, the membership were given financial statements "condensed from Arthur Young and Company's Audit Reports." These condensed reports were not qualified in any manner. They carried the gasohol plant at an expressed valuation of \$4.5 million, when in fact it had a value, for scrap, between \$500,000 and \$750,000. The membership were advised that they had a total members' equity of \$2.6 million as of the end of 1981 and \$1.4 million as of the end of 1982. The court understands that a jury may find that Arthur Young's representations simply read the condensed statements to the shareholders, without elaboration or qualification, even though the statements, without qualification,

were admittedly misleading. With these matters in mind, we will proceed to study the state and federal nonregistration and misrepresentation claims against the lawyers and accountants.

#### A. NON-REGISTRATION CLAIMS

The court has previously held the Co-op demand notes to be "securities" for purposes of the Arkansas securities laws requiring registration or exemption. Robertson v. White, 635 F. Supp. 853 (W.D. Ark. 1986). We did not then decide whether the notes were "securities" for purposes of the federal laws, but we now so hold. Our question is whether the lawyers and the accountants can be secondarily liable to the class for the Co-op's failure to register its demand note issue.

In Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981), the court held that a lawyer who prepared an opinion letter suggesting that the sales of silver coins on margin did not constitute a securities transaction was not liable to purchasers on federal registration claims. "In a suit for damages," the court said, "liability is imposed under § 12 of the Act, 15 U.S.C. § 77(1), on persons who offer or sell securities in violation of § 5. Thus, the conduct of the alleged aider and abetter must somehow bring him within the purview of § 12, which by its very language applies only to sellers." Id. at 785. Liability, the court held, is limited to those in privity with the buyers and those whose participation in the buy-sell transactions is a substantial factor in its taking place.

There is no evidence at all to suggest that any of the lawyers or accountants were in privity with any of the purchasers. It does not even appear, for purposes of the federal statute, that any of the lawyers or accountants performed any act which was a substantial factor in causing any one sale to take place, in the sense of "seduc[ing] the prey and lead[ing] it to the trap . . . ." Pharo v. Smith, 621 F.2d 656, 666, on reh'g, 625 F.2d 1226 (5th Cir. 1980). The Pharo court, whose opinion was cited approvingly by Stokes v. Lokken, supra, determined that it was necessary to show that a non-seller, or one not otherwise in privity with the buyer, was an inducing cause of the sale. This record falls far short of such a showing.

The question is different under the state securities act. First,

liability is not limited to persons who sell or control the seller, but rather extends to specifically enumerated parties, including "employees" who materially assist the sale. Ark. Stat. Ann. § 67-1256(b) (1980 Repl.). There is no suggestion that material assistance is limited to behavior which induces a sale; indeed, an argument can be made that persons of sufficient authority in the enterprise who perform ministerial acts at another's direction may be held liable for the sale of nonregistered securities. Furthermore, while the list of those statutorily liable under the law would appear to be exhaustive, the statute appears to indicate that such a roster is not meant to be exclusive. Ark. Stat. Ann. § 67-1256(h) says that the rights and remedies provided by the law are in addition to those otherwise provided by

law or equity. We take this to mean, in the context of a remedial statute, that if the common law were to offer a plaintiff a remedy against a person as a joint tortfeasor, who would otherwise escape liability because not an officer, director or employee materially assisting the sale, then subsection (h) should be applied to give the buyer a right and remedy against that party.

In Arkansas, all who "actively participate in committing a tort, or who command, direct, advise, encourage, aid or abet its commission, are jointly and severally liable." Lewis v. Mays, 208 Ark. 382, 186 S.W.2d 178 (1945). It does not appear to us that any of these defendants commanded, directed, advised or encouraged the sale of unregistered demand notes. The sales had been going on for two decades before any of these gentlemen

arrived on the scene. The most that can be said is that they failed to advise against the sales. Going farther out, the suggestion is made that defendants conspired to issue demand notes in order to keep the Co-op afloat.

It is now appropriate to deal with plaintiffs' remaining conspiracy theories. We have held that "an argument can be made" that Ball and Mourton conspired with White, Creekmore, and possible others to transfer stock of White Flame Fuels to the Co-op, and thereby involved themselves in a common law conspiracy to defraud and a conspiracy to violate the securities acts. The argument can be made because (a) it is not subject to dispute for purposes of this motion that a meeting took place on November 25 during which a plan was devised to finalize the transfer of the plant to the Co-op; and (b) that after the

meeting acts in furtherance of the plan were done by each individual said to be a party to the conspiracy. As a result, the Co-op was damaged. The only dispute concerns the animus of the various parties: innocent, negligent, reckless or fraudulent. In that connection, we found that jury questions were made out. If a party was merely negligent, of course he couldn't be a conspirator. But a jury was entitled on the evidence to find otherwise, and, if so entitled to find that the transfer proceeded by design.

By way of contrast, there is no evidence that these defendants conspired to sell demand notes. Certainly they knew the notes were being sold. The Co-op was selling these notes for two decades and everyone knew it. That is to say, one can hardly say that it was Mr. Ball's idea to sell the notes. Nor is there any evidence

that anyone even asked him his opinion whether they should be sold. Perhaps it was "negligent" for him not to fire off a letter demanding that all sales cease; however, we doubt that. He never agreed to act for the Co-op in that capacity. Maybe it was somehow advantageous for him to acquiesce in their sale. That is, however, not the same thing as conspiring to sell them.

What evidence is there that Ball and Mourton conspired to sell demand notes? There is one. Nor is there any evidence that Arthur Young conspired to sell the notes. A tendentious argument can be made that the Co-op had to attract financing any way it could, and that the professionals realized that Jack White's mismanagement would be discovered if access to capital were closed off. This does not prove a conspiracy "clearly and

convincingly" or lead a reasonable juror to "belief" in its existence. The first thing Arthur Young did was make entries reflecting demand note funds as 100% current liabilities, which drove the current rates down well below 1.0. Is one to suppose that this was done to encourage more demand note activity? Or at the behest of Creekmore? Or pursuant to a plan with Ball and Mourton? Or at White's direction? Why then was White so displeased with Arthur Young's 1981 audit? (Ex. 400). Was this merely a clever ploy to throw skeptical directors off his trail? The court is satisfied that no reasonable juror could conclude that Arthur Young conspired with anyone to sell unregistered demand notes. The plaintiffs bear the burden of proving this assertion clearly and convincingly, and they have not done so.

Anderson v. Liberty Lobby, 54

U.S.L.W. 4755 (1986), holds that a trial court must take into account the substantive burden of proof in passing on summary judgment questions. Specifically, it says that plaintiffs must offer "concrete" proof of matters such as conspiracy, *id.* at 4759, in the absence of which a judgment should be entered against the proponent. There is nothing concrete in this record suggesting that defendants conspired to mark the notes, and so they will be awarded summary judgment on that question.

Absent a conspiracy, we believe that there can be no finding of liability on the state and federal non-registration claims. The court does not believe that any of the defendants "induced" the sale of an unregistered demand note. Such a finding is apparently a prerequisite to

holding a person liable under the federal statute. We do not believe that it is necessary to show inducement under the state act. However, since the lawyers and accountants are not parties primarily responsible for seeing to it that the demand notes are registered in the first place, a finding of liability under Ark. Stat. Ann. § 67-1256(a)(1) would require a greater showing of responsibility for the illegal nature of the sale than is shown here. Any more dilute holding would automatically require all lawyers and accountants peripherally aware of any financial activity involving a client to make uncompensated inquiries (since they were not part of the engagement) into the often complex world of securities law at the risk of being found responsible for millions of dollars worth of rescinded transactions by plaintiffs looking for a

"deep pocket." Of course, if there were evidence to show that such parties induced sales of unregistered securities, or wrongly advised primary parties not to register their offering, or "controlled" the seller, then the law might very well hold such a party responsible, either directly, or by way of contribution on a cross claim. We say only here that at no time did Arthur Young or Ball and Mourton solicit, advise, or encourage the sale of unregistered securities, and at no time were they under any duties to run an independent assay of their clients' financial practices to assure compliance with the state and federal laws. As another court said in another context:

To accept the SEC's position [that auditors must perform closer examinations of a related company's account balances and assets, through which all the funds for the primary entity's programs were channeled] would go far toward making the

accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier with the accountant it would have caught the scent of wrongdoing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on the securities laws.

S.E.C. v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979).

To hold Arkansas accountants liable under the blue sky laws simply for failing to "pick up on" a client's failure to register his securities would conscript them for the advantage of the plaintiff's bar. Absent conspiracy, we find no warrant for that. We do not find that a reasonable juror can conclude that the accountants or

the lawyers knew that the corporation was selling unregistered securities; consequently, such secondary parties not being otherwise under a duty, like the directors, to find that out, we hold that they cannot be shown to be responsible for sales of unregistered securities.

B. FRAUDULENT SALES OF DEMAND NOTE  
SECURITIES UNDER RULE 10b-5 AND THE  
ARKANSAS BLUE SKY LAW

The court has had extreme difficulty parsing the class's 10b-65 complaint. We note, for example, that the 10b-5 violations are alleged to have commenced, with respect to the class, in "February 1980." (Consolidated Complaint ¶ 119) We gather from that allegation that plaintiffs have chosen the earliest possible date on which the gasohol plant might fraudulently have been transferred to the Co-op. If the Co-op "owned" the plant

earlier than that time, the inference of fraud in the underlying transfer diminishes. The inference of later fraud becomes also less plausible. If the Co-op was an "owner" of the plant as far back as May, 1979, the inference of fraud in the underlying transfer diminishes almost entirely. It takes on, rather, the cast of a very bad deal, a foolish investment, the kind of misfortune which has so often attended parties investing in "alternative energy sources" over the past dozen years or so.

However, it cannot be the transfer of the plant, simpliciter, which constitutes a 10b-5 violation with respect to the class. As we explained earlier, that alleged fraud harmed the Co-op unitarily, and not its investors distributively. See Robertson v. White, 633 F. Supp. 854, 865 (W.D. Ark. 1986).

Rather, sales of demand notes occurring after the transfer are the only ones infected by the bacillus of 10b-5, and then only because the Co-op, through its newsletter and other media, made statements to the public which were misleading (because incomplete) or untrue.

Our first difficulty, then, is with the "February, 1980" date. It is, in a word, imprecise. We do not have to solve the mystery of when during February the 10b-5 violations began (the first sale after the "decision" to buy the plant on February 15, 1980?) because we believe that the limitations period began later.

Briefly, the Co-op filed bankruptcy on February 23, 1984, and on February 15, 1985, Tom Robertson, the trustee, brought suit on behalf of the Co-op and demand noteholders, alleging 10b-5 violations, inter alia. Several

defendants protested his standing as a class representative, Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972), and on May 8, 1985, the class of demand note buyers petitioned to intervene in Robertson's suit alleging class claims, including this 10b-5 action. We believe that only the class filing, and not the trustee's filing, tolls the limitation period.

First, the trustee is not now and has not ever been a member of the class. He represents, and always has, an entity hostile to the class, although he administers the estate in their behalf. This is not a case such as American Pipe and Construction Co. v. Utah, 414 U.S. 538 (1974), or United Airlines, Inc. v. McDonald, 432 U.S. 385 (1977). In those cases parties who at least potentially had standing to file on behalf of a class were

deemed to have tolled limitations periods for their brethren, even though the class was never certified because of numerosity questions. Fed. R. Civ. P. 23(a). Nor is this a case where the class allegations are stricken because the plaintiff, even though a member of the class, is deemed to be an inferior representative for their interests. Here, plainly and simply, on the face of the complaint, the trustee is legally disqualified from bringing an action on behalf of the class.

In this case we have no hesitance in holding that the trustee's filing did not toll the limitations period from running against the class. To permit such a filing to toll the period encourages an officiousness by interlopers we should be vigilant to check, and needlessly deprives defendants of a repose which the statute creating the right determines that they

should enjoy. A disqualification of a class representative because of supposed inadequacy is premised on factual determinations which no one is presumed to know; whereas the trustee's disqualification in this case is a matter of legal standing, deducible from the complaint. Everyone is presumed to know that a trustee cannot represent creditors on their personal causes of action, as that is the law. One who acts in ignorance of the law does so at his own peril, a lesson which the trustee vividly imparted to the directors not four months ago. Thus, if any class member had looked at the complaint, he would have been on notice that the trustee's standing was questionable, and on notice to protect his own rights. But since the cases do not require or even presume reliance by passive class members, American Pipe and

Construction Co. v. Utah, supra, at 551-553, our question becomes whether non-vigilant parties should be able to defeat a substantive right of repose given defendants because of the actions of a pure interloper. We do not believe that they should. Manifestly, in a case such as this, the court's interest in avoiding a multiplicity of actions and promoting litigational "efficiency," American Pipe, id. at 553, is not served by tolling the statute. Here it is the trustee's initial class suit which caused the "multiplicity." Until a proper potential class member filed, there was not even a case or controversy for us to decide with respect to the class.

Second, the trustee suggests that Carl Greul's November, 1984, securities filing in Oklahoma tolled the period for a year. This action was later voluntarily

dismissed. We disagree for a number of reasons: (1) the Oklahoma filing did not name these defendants; (2) the Oklahoma complaint did not put them on notice in such a manner that, had it been amended, it would have "related back" against these defendants under Fed. R. Civ. P. 15; (3) the savings statute giving plaintiffs a year to refile the action after voluntary dismissal does not apply to statutory causes of action carrying their own special limitations periods. See Sandusky v. First Elec. Coop., 266 Ark. 588, 587 S.W.2d 37 (1979).

We decide, therefore, that the limitations period starts, at the earliest, on May 8, 1980, five years before the class filed its petition to intervene. [We borrow the limitations period in the Arkansas Securities Act, because it is most cognate for purposes of 10b-5 questions.

Also, implicitly, the Eighth Circuit recently approved borrowing limitation from a state blue sky statute in Harris v. Union Electric Co., 787 F.2d 355 (8th Cir. 1986); see also Vanderboom v. Sexton, 460 F.2d 362, 363 (8th Cir. 1972) (borrowing Arkansas blue sky statute's limitations period for purposes of 10b-5).

For sales of demand notes occurring after May 8, 1980, we are directed to the following series of questions: (1) whether there was a fraudulent manipulation by the Co-op or any of the defendants prior to the events of November 12, 1980 - December 19, 1980; (2) whether there was a 10b-5 manipulation occurring after November 12/December 19; and (3) the extent to which Creekmore can be liable to any sales occurring after December 31, 1980.

One thing must be kept clear: the transfer of the gasohol plant to the Co-op does not constitute a 10b-5 violation vis a vis the class. Since the Co-op received, or purchased, all of White Flame's shares, White and his confederates may be liable to the trustee under 10b-5; however, White and his confederates are not liable to the class. The court doubts that this demands much explanation, given the pains taken by the court to distinguish between corporate causes of action and shareholder causes of action in its earlier opinion. Our holding on this point, however, is not merely an application of that ruling. Rather, it proceeds from the nature of the 10b-5 cause of action itself.

10b-5 offers remedies to persons defrauded "in connection with" their decision to purchase or sell their stock. Blue Chip Stamps v. Manor Drug Stores, 421

U.S. 723 (1975). The problem is conceptually different, therefore, from a question whether a shareholder has a personal cause of action against a party who defrauded his company. Blue Chip Stamps denies 10b-5 relief to shareholders, extending it only to parties who purchase or sell shares "in connection with" a fraud.

The class's 10b-5 claim properly concerns itself not with events leading up to the transfer of the gasohol plant to the Co-op, but with manipulations occurring afterwards to conceal the financial status of the depleted corporation. As the court is able to understand the factual issues, the "earlier on" the Co-op legitimately acquires the gasohol plant, the less materially misrepresentative are any of its statements and presentations to its membership and demand note buyers.

Accountants assign different values to a fixed asset depending on whether the enterprise purchases it from another source, or constructs it on its own. If the Co-op "always owned" the gasohol plant, then its capitalization could vary significantly from a value attributable to the plant if it were purchased substantially complete and ready to produce from Jack White in February, 1980. Under the latter hypothesis, a significant part of the moneys expended by the Co-op after that date would have to be expensed.

Furthermore, if the Co-op "always owned" the gasohol plant, there would be no need, especially, for the Arthur Young accountants to procure an appraisal of the plant. But if the transaction by which the Co-op acquired the plant were a "business combination," then they may have been required still to carry the asset on the

books at "cost," but with this difference: the asset would need to be valued, and any excess of cost over market would have to be assigned as "good will." (Accounting Practices Board [APB] Opinion No. 16, ¶ 87). It is possible that Arthur Young would have had to have carried as much as \$3.7 million of good will before the membership.

One can easily see the advantages to Jack White of an accounting/auditing procedure which postulated that the Co-op "always owned" the gasohol plant. What the court frankly has a good deal of difficulty understanding is Arthur Young's apparent inconsistency in treating the plant as having always been owned by the Co-op. When Harry Erwin of Arthur Young was asked about the gasohol plant by the Co-op membership during the 1982 meeting, he evaded questions about it, saying that it

was "a separate operation" (AY 011090) under "state law." The questions at this meeting, recorded in the minutes, appear decidedly hostile to the Co-op's management. Expenditures on legal fees and the gasohol plant were closely questioned. One can imagine just what questions would have been asked if the Co-op's members' equity were completely consumed by "good will." To most laymen in this area, "good will" means "the old folks going to the old store," a concept difficult sensibly to apply to a gasohol plant. A jury may conclude, in fact, that if Arthur Young had used an accounting treatment more in harmony with the facts, reorganization proceedings would have begun much earlier. Obviously, people buying notes after that date would not have been injured in their property. The question is whether Arthur Young's accounting treatment, which we have

earlier held to be capable of being deemed at least reckless by a reasonable jury, violates the anti-fraud provisions of state and federal law. Arthur Young argues that there can be no securities fraud liability extending to it because no one specifically relied on any of its representations concerning the financial status of the Co-op. As we mentioned, in dealing with Count IV of the complaint, this is a potent defense to any claims made under the common law. We are not convinced that this is the case under the securities laws.

#### I. THE ARKANSAS ANTIFRAUD SECURITIES LAWS

The Arkansas Securities Act  
provides:

Civil liability -- (a) Any person  
who

(1) . . . . ,

- (2) offers or sells a security by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission) . . . is liable to the person buying from him . . . . (emphasis added).

The court understands that the state law, by its very term, makes "reliance" by the buyer irrelevant; instead, the seller may avoid liability by proving that the buyer knew the truth. The Uniform Securities Act, upon which this section of the Arkansas Act was almost identically modeled, does not require a showing of reliance. As the Commentary to the Uniform Act declares:

The "by means of" clause in line 8 is not intended as a requirement that the buyer prove reliance on the untrue statement or omission. He must show only that he did not know of it. See Murphy v. Cady, 30 F. Supp. 466, 468 (D. Me. 1939), aff'd

sub nom., Cady v. Murphy, 113 F.2d 988 (1st Cir. 1940), cert. denied, 311 U.S. 705, under § 12(2) of the Federal Statute.

Uniform Securities Act, Draftsmen's Commentary to § 410(a). The federal act, of course, has a limitations period of one year, instead of five, and the class did not commence its action until fifteen months after bankruptcy was declared. Thus, claims which are barred under § 12 of the federal Securities Act of 1933, because of the passage of a year, can find a home within the Arkansas Blue Sky law, whose cognate provisions enjoy a five-year limitation period. Ark. Stat. Ann. § 67-1256(e).

The remaining question for decision is whether parties such as accountants and lawyers, who do not "control" a seller, are liable under the law. Ark. Stat. Ann. § 67-1256(b) states

that "every person who controls a seller liable under subsection (a) . . . every partner, officer, director . . . every person occupying a similar status or performing [a] similar function, every employee of such seller . . . who materially aids in the sale . . . are also liable jointly and severally with . . . the seller . . . ." (emphasis added).

The statute gives defrauded parties not only rights against the "seller," i.e., the Co-op, but also against individual directors and employees of the Co-op. It departs from the common law in this respect. Under the common law, one is not given a right of action against a corporate director simply because the third party was tortiously injured by the corporation. Washington Gas Light Co. v. Landsden, 172 U.S. 534 (1899). Furthermore, a director or officer of a

corporation is not liable, merely because of his official character, for the frauds or false representations of the other agents of the corporation, or for fraud attributable to the corporation itself, if such officer or director is not personally connected with the wrong and does not participate in it. Teledyne Industries, Inc. v. Eon Corp.,\* 401 F. Supp. 729 (S.D.N.Y. 1975), aff'd, 546 F.2d 495 (2d Cir. 1976). Of course, the rule is otherwise if the officer or director participates in the fraud -- he is liable like any other joint tortfeasor.

The Arkansas Securities Act invades the common law to the extent that it enumerates parties who might not ordinarily share liability with the "seller," and imposes a statutory rescission liability against them. We do not believe that Ark. Stat. Ann. § 67-

1256(b) is meant to supplant the common law, by exculpating those parties who otherwise would be liable as joint tortfeasors, or "aiders and abettors" if you will. Indeed, subsection (h) of the same statute says: "The rights and remedies provided by this act are in addition to any other rights that may exist at law or in equity."

The court believes that it would be contrary to the remedial purpose of the law to permit an active tortfeasor to escape liability in this situation. If the jury were to find that once Jack White left the Co-op in 1982, that the only persons who were aware that the Co-op was actually insolvent were the accountants and that, out of a misplaced loyalty, the accountants decided to distort the Co-op's true financial picture, knowing that people were actively investing in the enterprise: does

it "make sense" that the only parties who could be held responsible under the law were the directors, whose intent was non-fraudulent? The law would require them to prove that they did not know of the insolvency, which would mean that they would produce the audit report and claim a "good faith defense." The case against the directors would fall because they had no way of knowing (or suspecting) that accountants would perversely issue a deliberately distorted report. The accountants would claim that no common law action could be maintained against them because no one specifically relied on what they did say; although, conversely, no one would have bought a security if they knew the Co-op to be insolvent. Only if the directors failed to prove "good faith" would the accountants ever be called to court for their misdeed, because they would

be liable to the directors in contribution. (Ark. Stat. Ann. § 67-1256(b)). The defrauded parties, under this restrictive view, could have no direct rights against the only parties responsible for the fraud. All of this obtains from a statute designed to "protect investors" by encouraging "full, truthful disclosure."

The court believes that the Arkansas Securities Act contemplates, through subsection (h), that parties who at common law would be jointly and severally liable with the "seller" for the sale of securities "by means of any untrue statement," should be liable under the blue sky law as well. These would include the Arthur Young accountants who breached a duty owed to the class. Under the Restatement (Second) of Torts § 876(c), a party is subject to liability to another harmed by the acts of a third party if he

"gives substantial assistance to the [third party] in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person." We have already discussed, supra, with respect to Count IV of the complaint, how the Arthur Young accountants owed a duty to the members of the class not to intentionally misstate the Co-op's financial status. The common law recognizes that duty, but holds that one may not be liable where the "victim" did not rely on the statement, or even if he did not "reasonably rely" on it. "Reliance" under the common law is a measure not of the defendant's duty, but of causation for the plaintiff's loss. Under the Restatement's test, an accountant can be held jointly liable with a seller for fraudulently misrepresenting financial information in a securities transaction.

Alternatively, the accountants can be said to exercise sufficient "control" over the seller, with respect only to the dissemination of misrepresentative material, to justify the imposition of liability under § 1256(b). "Control" is not defined by the statute. However, in Hawkins v. Merrill Lynch, 85 F. Supp. 104, 123 (W.D. Ark. 1949), the court noted that in the context of the federal statutes, "control" did not mean "that degree of control or the right to direct necessary to make out a common law relationship of principal-agent or employer-employee." The court believed that a more flexible meaning was intended by Congress.

We believe that the same be said for the Arkansas blue sky law. If a third party has the power to influence the way that financial information is disseminated to the public, he exercises some measure of

control over the seller and the transaction. The record shows that Arthur Young reviewed the condensed financial statements, and perhaps in a sense approved them. The evidence tends to show that they were given proofs of the 1982 statements with notations saying that the materials were prepared from an audit report conducted by Arthur Young & Co. It would appear that at that point, certainly, Arthur Young & Co. had the "power" to protest the way in which its name was used to project materially misleading information. The court hesitates to say that this power automatically amounts to control of an issuer for all purposes; however, for the limited purpose of determining Arthur Young's ability to influence the course of dealing by the Co-op, it is not insignificant that the Co-op passed the materials on to Arthur

Young "for approval" and Arthur Young chose not to exercise its prerogatives, though it certainly could have, and would have been more than justified in protesting the use of its name in that context.

We believe, therefore, that Arthur Young's motion for summary judgment on the state anti-fraud statutes should be denied. Plaintiffs do not have to prove reliance, and, we believe, are capable of bringing actions against responsible parties not specifically named in the statute.

We do not believe, however, that any evidence has been adduced showing Ball and Mourton to be responsible for any state securities law violations, or showing Carl Creekmore to be responsible after December 31, 1980, when he retired and ceased being, even arguably, a "controlling person." The court will grant Ball and Mourton summary judgment on these claims, and Carl

Creekmore a partial summary judgment. If it appears that no demand notes were sold "by means of" an untrue statement of material fact before December 31, 1980, Carl Creekmore can move for a verdict on the evidence with respect to those issues as well.

Defendants have also filed motions for summary judgment against the class's 10b-5 claims. We are in greater sympathy with defendants' motions under the federal laws than we are under the blue sky law. Rule 10b-5 at least arguably requires a showing of reliance missing from plaintiffs' proofs. We note, however, that the element of reliance -- not mandated by the rule -- has been eroded partly by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), and partly by the Eighth Circuit in Barnes v. Resource Royalties, Inc., No. 85-1715, CCH

¶ 92,808 (8th Cir. 1986). We believe it therefore best at this time to deny Arthur Young's motions for summary judgment under Rule 10b-5. First, the same evidence and basically the same theories will be ventilated in both the state and federal law securities claims. To the extent that there is any departure, it is in the area of damages, and we have not yet decided whether damages will be heard by the jury or by the court. (This matter was left unresolved by our October 9, 1986, pretrial.) Second, the court believes that it will be far more strategically placed to reconsider this motion at trial, when the question will be presented on a more complete record. The court confesses having some difficulty reconciling Vervaecke v. Chiles Helder, 578 F.2d 713 (8th Cir. 1978), with some of the more recent pronouncements from our court of

appeals. It "makes sense" to the court that every misrepresentation contains within itself the seeds of an omission; and that, therefore, unless it is watched, the Affiliated Ute presumption will swallow all reliance requirements under Rule 10b-5. The court frankly views cases like Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), as sounding an end to the expansionist notions of the securities laws expressed in Affiliated Ute Citizens v. United States, *supra*, and Superintendent of Insurance v. Banker's Life & Casualty Co., 404 U.S. 6 (1971), both older cases. This concern is especially pronounced because of Blue Chip Stamp's reference to the appropriateness of advertizing "to the tort of misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship." *Ibid.* at 744. We understand the discussion following that

reference to relate that transactions on an impersonal market may justify a departure from rules of earlier days. We wonder, then, in this connection, why the cases promoting a relaxation in the rule have occurred in face-to-face transactions: Affiliated Ute involved discrete contacts between the "market making" bankers and the Indians; Barnes v. Resource Royalties, supra, involved non-market transactions between a buyer and a seller. Only Union Electric Co. v. Harris, 787 F.2d 355 (8th Cir. 1986), concerns an omission misleading the market. Defendants question its applicability to our case because there was no "market" for Co-op demand notes: the "loss causation" in Harris v. Union Electric, supra, was a result of the misrepresentation and the effect of its disclosure on "the market." Here, the underlying business problems caused the

loss, not the alleged misrepresentation. Arguably, the misrepresentations in this case were neither "transaction causative," or, strictly speaking, "loss causative." Rather, they merely "failed to deter" transactions. The court has a great many questions whether a representation which failed to induce a transaction should be civilly redressed under 10b-5 because it failed to deter one.

With respect to Ball and Mourton, and Carl Creekmore, the court finds no evidence that they conspired to market the demand notes or otherwise are liable for the violations of Rule 10b-5. Creekmore, again, will be given only a partial summary judgment for any transactions occurring after December 31, 1980. If the facts show that no material omissions tainted sales made before that time, or if otherwise appropriate, we will entertain a later

motion from him on the federal securities laws claims.

VII. COUNT XII: RICO ACTIONS AGAINST THE LAWYERS AND ACCOUNTANTS

Defendants' legal objections to plaintiffs' RICO causes of action are twofold: first, that plaintiffs cannot prove that the lawyers and accountants participated in the management or control of the Co-Op, Bennett v. Berg, 710 F.2d 1361, 364 (8th Cir. 1983) (en banc); second, that plaintiffs cannot prove that the lawyers and accountants managed any enterprise "through a pattern" of racketeering activity. Holmberg v. Morrisette, No. 85-5138 (8th Cir., slip op. Sept. 3, 1986); Superior Oil Co. v. Fulmer, 785 F.2d 252 (8th Cir., 1986).

To the extent that plaintiffs base their case against Arthur Young and Co. on

allegations that it participated in the operation or management of the Farmers' Co-Op, they must fail. Plaintiffs have compiled an extensive record; yet, from it they are able to show just five acts by Arthur Young which they suggest support a finding of control: (a) the accountants allegedly created the Co-op's financial statements; (b) the accountants failed to obtain client representation letters; (c) they addressed shareholder meetings; (d) they participated in the creation of condensed financial statements; and (e) the accountants helped the Co-op handle certain matters with government agencies. Perhaps the court misunderstands plaintiffs' theories in this regard, but these activities hardly bespeak the kind of "operation and management" with which we understand Bennett v. Berg, Ibid., to be concerned. Plaintiffs have failed to show

anything more than that the accountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceding the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by Bennett v. Berg, Id.

Conceding that the question of "control" is closer with respect to the lawyers Ball and Mourton, and Carl Creekmore, we nevertheless find that a RICO case has not been made out against them because plaintiffs have failed to prove that they conducted the affairs of the Co-op through a pattern of racketeering activity. In Sedima v. Imrex, 105 S.Ct. 3275 (1985) the Supreme Court observed in

passing that the lower federal courts had failed to develop a meaningful definition of "pattern" in RICO cases, a failing, we submit, for which Congress is primarily liable, having authored the legislation without defining a critical term. That the Sedima court would footnote this issue, one which was not raised by the questions raised in the certiorari petition, nor certified by the court for review, is an indication that the court was troubled by the indiscriminate use of RICO by plaintiffs victimized by otherwise unremarkable frauds.

We are persuaded by two recent Eight Circuit opinions that plaintiffs have failed to prove that the lawyers participated in the conduct of the Co-op through a pattern of racketeering activity. The earlier opinion of the two held that a single long-running scheme victimizing a

single entity does not constitute a RICO pattern. Superior Oil Co. v. Fulmer, supra. The latter opinion held that multiple parties separately victimized by activities relating to a single transaction are confined to their common law remedies since a showing of activity connected with a single transaction negates a finding of a "pattern" of racketeering activity. Holmberg v. Morrisette, supra.

In Superior Oil Co. v. Fulmer, Supra., three individuals siphoned natural gas from a pipeline for refining and resale, covering up their misdeeds by posting a number of fraudulent meter readings through the mail. There was no evidence that the three committed other acts of the same tenor, or that they had ever attempted to do so. The court of appeals reversed a jury verdict finding the three liable for damages under RICO saying:

"...[P]roof of a 'pattern of racketeering activity' 'requires more than one "racketeering activity" and the threat of continuing activity to be successful. It is this factor of continuity plus relationship which combines to produce a pattern.' ...Superior Oil clearly has proved the 'relationship' prong [sic]. They proved several related acts of mail and wire fraud in pursuit of the underlying conversion or theft of gas from Superior Oil's interstate pipeline....

Superior Oil has, however, failed to prove the 'continuity' sufficient to form 'a pattern of racketeering activity'. The actions of Fulmer, Branch and Nichols comprised one continuing scheme to convert gas from Superior Oil's pipeline. There was no proof that Fulmer, Branch or Nichols had ever done these activities in the past and there is no proof that they were engaged in criminal activities elsewhere.

Superior Oil attempted to show that Fulmer, Branch and Nichols intended to engage in similar gas conversion schemes at other locations. Although it may be that proof of a threat of continuing racketeering activities in the future could, in combination with ongoing acts of racketeering, be

sufficient to establish a 'pattern of racketeering,' we find insufficient proof of such a threat here."

The Fulmer court, in short, agreed with Northern Trust Bank/-O'Hare N.A. v. Inryco, Inc., 615 F.Supp. 828, 832 (N.D. Ill. 1985) which said that "[i]t is difficult to see how the threat of continuing activity stressed in the Senate Report could be established by a single criminal episode," noting that "[i]t places a real strain on the language to speak of a single fraudulent effort, involving several fraudulent acts, as a 'pattern of racketeering activity'."

We view Superior Oil as imposing a "single scheme" limitation on civil RICO cases. Where repetitive criminal activity expresses itself in a single fraudulent effort, the victim will be left to his common law fraud remedies, just as he was

in pre-RICO days. We read Superior Oil to hold that the federal interest is ignited only when a party mounts repetitive efforts in distinct episodes.

Whatever doubts we may have entertained about Superior Oil's single scheme limitation were removed by the Eighth Circuit's more recent decision in Holmberg v. Morrisette, supra. The court of appeals decided that the trial court erred in holding the defendant liable under RICO where the plaintiff (one of three parties each of whom was separately defrauded by the defendant,) was held to have been victimized only in connection with a single scheme, and not otherwise in connection with a pattern of racketeering activity. In Holmberg, three letters of credit, issued by the victims, separately secured the defendant's interest in a business transaction involving an exporter.

To avoid a loss, defendant forged invoices and bills of lading to draw down the letters of credit. Even though the Holmberg facts (three separate acts, three different victims) differed from Fulmer's (one continuous siphoning, one victim), the Eighth Circuit declined to characterize this departure as material for purposes of civil RICO. The court said:

"This court thoroughly discussed the parameters of 'pattern' in Superior Oil Co. v. Fulmer... In Superior Oil, we held that several related acts of mail and wire fraud as a part of a single scheme to divert natural gas ... did not amount to a racketeering activity. There was no evidence suggesting that such activities had occurred previously or that the individuals involved were engaged in other criminal activities....We believe the present case is legally indistinguishable from Superior Oil...

....

We assume for purposes of our review that Holmberg proved that defendants committed acts of wire or mail fraud related to a common purpose or scheme. Our review of the record

convinces us, however, that Holmberg has failed, as a matter of law, to prove the continuity necessary to form a 'pattern' of racketeering activity. Defendants' actions comprised one scheme to draw down the three letters of credit securing Mintex's transactions with TransWorld with respect to goods specially produced by Mintex....In one sense defendants' actions were a misguided attempt to obtain payment for goods which they had produced, yet over which they had no control."

In this case, the evidence suggests that the lawyers combined to unload the gasohol plant on the Co-op. There is but one scheme. The plaintiffs' expressed theory of the case, as manifested in the Consolidated Complaint, charged all the defendants with "a [single] scheme to allow the Co-op to continue in existence, notwithstanding the depletion of its assets by looting". (Complaint ¶158). Somewhat tardily, plaintiffs suggest now that RICO case can be made against the lawyers because they twice victimized the Co-op:

once to secure payment of White's legal fees, and once to transfer White's gasohol plant out of his hands.

One need only examine plaintiffs' introduction to its response to Ball and Mourton's motions for summary judgment to find expressed by plaintiffs their own view that the allegedly wrongful acts of the lawyers swung on a single pivot: the December 11, 1980, meeting of the Co-op Board. There Creekmore secured the authority to file both the declaratory judgment action, as well as a resolution authorizing the Co-op to pay the legal fees of White and Kuykendall. From that one meeting emerged a single victim (the Co-op) allegedly bilked by a single fraudulent device (fiduciaries serving masters with conflicting interests) for the direct benefit of one party (White). Collateral

benefits flowed to others, of course, but that fact is unimportant to this analysis.

The allegedly fraudulent activities in this case took place at one time and involved the same people. We do not believe that the Congress's concern that only continuing, repetitively manifested activities be redressed by RICO will be served if we indulge pleading fictions that balkanize essentially unitary transactions. The Eighth Circuit has twice clearly spoken against creative analyses of transactions that "plead defendants into RICO." A common sense view of the record seems to be clearly called-for. Where a single scheme appears, plaintiffs should be left to their common law remedies, unless the plaintiffs can show that the defendants "did it before and would do it again." In such an event, RICO manifestly has its

place, and needs no artful pleading to secure it.

Even if the law allowed plaintiffs to make two schemes out of a single meeting of the Board, we believe that the payment of legal fees by the Co-op is not such a cause of action as necessarily sounds in fraud. Our view of the trustee's suit in Count I is that the gravamen of the action is one for money paid by mistake, sounding in restitution. Indeed, the cases upon which we relied in sustaining the trustee's claim acknowledged that recovery could be obtained without a showing of scienter. Among the theories suggested by the authorities as substantiating a claim in cases such as this one is "conversion" which, as Prosser notes, "defies definition," having its genesis in the law of trover, requiring only that plaintiff prove his right to possession and the

defendant's exercise of dominion over the chattel. Prosser and Keeton, Torts, 5th Ed. 1984, pp. 88-90. We may at leisure criticize the expansion of "conversion" to reach the receipt of money; however, in so doing, we note a recognition by those courts that such a claim is one which, like conversion, does not require a pronounced mental element.

We therefore believe that a pattern of corrupt management of the Co-op has not been proved. We would emphasize that "management" by the lawyers has been assumed rather than found. We do not wish to intimate that attorneys are especially prone to be found to control RICO enterprises simply by virtue of their calling. We suggest only that the question of "control" in this case is harder to reach than the question of pattern. Our findings, however, do not end our RICO

inquiries, since plaintiffs have also charged that the lawyers and accountants operated their own firms as RICO enterprises, through a pattern of racketeering activity.<sup>5</sup>

Defendants E.J. Ball and Ken Mourton obviously participated in the management of the enterprise "Ball and Mourton." The individual Arthur Young accountants obviously participated in the management of Arthur Young. There is no proof in this record that either of these enterprises has been conducted through a pattern of racketeering activity. Rather, what we find is that to the extent that any of these lawyers' or accountants' dealings with the Co-op are wrongful, such dealings

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<sup>5</sup> [Creekmore was not charged with having operated his own practice in that manner; consequently, the RICO cause of action as to him is dismissed with no additional comment.]

are aberrant, and in no way "typical" of the practice of these professionals.

We have mentioned our belief that the Superior Oil case imposed a scheme limitation on RICO. To the extent that an "outsider" directs or influences the affairs of an enterprise, we believe that RICO plaintiffs are obliged to show that he did so through a pattern of abuses. Such a pattern, we believe, cannot be found in events having a nexus to a single transaction. Such a limited showing simply does not permit a reasonable juror to conclude that the "outsider" intends to pervert the enterprise into an ongoing, continuing engine of fraud.

If the person charged under RICO is an "insider" in his own "enterprise," it is even less likely, as the Sedima court suggested, that two acts or schemes will suffice to prove a pattern. A person

acting through the enterprise of another obviously has fewer opportunities to influence its behavior than he does when acting through his own. This is obviously true in the cases of large law firms and accountancy firms, which will have the opportunity to "manage", loosely speaking, the affairs of hundreds and thousands of clients at a time. In a large and varied practice, a person who twice corrupts a single "outside" enterprise will more likely be found to have managed that particular enterprise through a pattern of wrongful activity, than he would his own. His "management" of the foreign enterprise may only consist of a limited number of transactions, and his readiness to exploit his association can be measured, quantitatively and qualitatively, against a much smaller range of activity. In such a case, two schemes may suffice.

When managing his own enterprise, wherein thousands of people are concerned and many times that many transactions are implicated, it is correspondingly harder reasonably to find a pattern of corruption arising out of only two discrete and widely separated acts. For example, if a professional service corporation were to send a single inflated bill to a client in 1973, and another to another client in 1982, it could hardly be said that it conducted its affairs through a pattern of racketeering activity. Sedima v. Imrex, supra, acknowledged the unreasonableness of finding a pattern in such activity, without holding that a pattern can never be found from a showing of two acts or schemes. The court believes that it is possible to find that an individual managed an entity through a pattern of racketeering activity if his "management" were found to

consist of a sufficiently limited number of discrete acts, two of which were distinctively and separately fraudulent. Obviously, however, where one acts through his own enterprise literally thousands of times a year, it beggars sense to require him to stand trial under RICO for two overbillings occurring nine years apart.

We believe that RICO claims are most likely to be predicated on "two schemes" when a court is convinced that the schemes are qualitatively and quantitatively significant enough so as to permit a reasonable jury to conclude that they are somehow "characteristic" of the way a person conducts the affairs of an enterprise. If a person uses his business twice as an engine of fraud against the public in large scale securities offerings, the very distinctiveness of that behavior may reasonably permit one to conclude that

the defendant is determined to use his business as "a racket." By imposing a single scheme limitation on RICO, the courts are only forcing the statute to live up to its name. After all, any kind of fraudulent activity above the level of Three Card Monte will involve more than two acts of mail or wire fraud. An interpretation of RICO which permits every such scheme trebly to be redressed essentially invites every fraud case to be filed in federal court. This would especially be so if, as plaintiffs suggest, RICO frauds need be proved only by a preponderance of the evidence, whereas common law frauds must be proved clearly and convincingly.

The record is devoid of proof that Ball and Mourton ever operated the affairs of Ball and Mourton so as to defraud any other party, and likewise that any of the

individual accountants ever operated Arthur Young so as to defraud another. We therefore conclude that summary judgment must be entered on behalf of Ball, Mourton, Erwin, Cabannis, Drozal and Harrison. They neither controlled or managed the Co-op through a pattern of racketeering activity, nor their own firms. For these reasons as well, we dismiss Arthur Young's RICO crossclaims against the directors. Such claims, if they exist, clearly related to a single transaction or purpose, allegedly to keep the Co-op afloat.

#### VIII. CONCLUDING MATTERS

The remainder of the motions address allegations which have been thoroughly ventilated. For example, Ball and Mourton pray for summary judgment on Count VII which charges that they should return fees paid by the Co-op because they

represented dual interests. We have already said that such an issue can be submitted to the jury as an element of other causes of action; the same is true when the trustee seeks a return of fees. It would appear that Ball and Mourton stopped representing White in March, 1982. The court does not know whether the lawyers should be required to return fees for periods in which there was no conflict. In any event, that is an argument over "how much" not over "whether" and therefore not appropriate, we think, for summary judgment.

Similar dispositions will obtain for limitations issues, the existence of negligence questions, etc., etc. One must also bear in mind that damage issues, including punitive damages against these remaining defendants, have not been discussed fully, largely because they

haven't been raised fully. Our decision that Ball and Mourton and Carl Creekmore performed no "acts" inimical to the Co-op after January, 1981, for example, does not foreclose the plaintiffs from proving that the Co-op suffered damages later which were proximately caused by them. We simply fail to find that these parties breached any duties owing to the various plaintiffs.

The case, we believe, is now ready for trial. Basically, the jury will be studying the events of May, 1979, to December, 1980, and in that connection will be focusing on the lawyers. A later focus will center on the events of August, 1981, to February, 1984, involving the accountants, especially with reference to damages suffered by audits presented in the spring of 1982 and 1983. Plaintiffs have not proven a conspiracy that would unite these events. One of the attractions of

such theories is that they always "explain a lot." They are easy to hypothesize, harder to prove. This record offers no proof of an agreement, without which it would be plainly unjust to permit such an allegation to go to trial. We have had the occasion to study the plaintiffs' claims that certain of these defendants are alleged to have "made up" a state of facts that allowed them to reach a result they desired. On the record presented by this case, the court would be guilty of that which the plaintiffs attack if we were to allow the jury to "make up" a scenario having no basis in the evidence simply to reach a result agreeable to the plaintiffs. We have therefore steered a course set by the polestar of Anderson v. Liberty Lobby, Inc., 54 U.S.L.W. 4775 (1986), and have dismissed those claims because they utterly lack "concrete" support and could never

persuade a reasonable jury, clearly and convincingly, that such a state of facts exists.

An order will be issued contemporaneously herewith embodying these conclusions.

This 15th day of October, 1986.

/s/ H. Franklin Waters  
United States District Judge

IN THE UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF ARKANSAS  
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as  
Trustee of the Farmer's Co-Op  
of Arkansas & Oklahoma, Inc.;  
BOB REVES; FRANCES GRAHAM;  
ROBERT H. GIBBS, individually;  
ROBERT H. GIBBS, as natural  
guardian of his minor children,  
THOMAS A. GIBBS and  
ROBERT H. GIBBS, JR.;  
and ROBERT H. GIBBS, as Trustee  
of the Muskogee Internal  
Medicine Group Profit  
Sharing Funds

PLAINTIFFS

v. Consolidated Cases No. 85-2044  
85-2096  
85-2155  
85-2259

JACK E. WHITE, ET AL.

DEFENDANTS

ORDER

Now on this 16th day of October, 1986, comes on to be heard defendants' motions for summary judgment. The court, on reviewing the pleadings, affidavits, depositions, exhibits, and other matters, finds:

1. That the motions of Arthur Young, and Ball and Mourton, for summary judgment on Count I are denied;
2. That the motions of Carl Creekmore, and Ball and Mourton for summary judgment on Count II are denied, with the exception that Carl Creekmore's plea of a bar by limitations is granted with respect to the Trustee's action for negligence;
3. That the motions of Carl Creekmore, and Ball and Mourton for summary judgment on Count III are denied;
4. That Carl Creekmore's and Ball and Mourton's motions for summary judgment on Count IV are granted; also, that Arthur Young's motions for summary judgment on claims brought by the class in Count IV are granted; however, Arthur Young's motions against the Trustee's claims for fraud and negligence are denied;
5. Carl Creekmore's and Ball and Mourton's motions for summary judgment on Count VI are granted; Arthur Young's motions for summary judgment on Count VI are denied;
6. The motions of all defendants on Count XIII (R.I.C.O.) are granted.
7. The motions of Ball and Mourton on Counts VII and XI are denied; the motion of Carl Creekmore on Count

XI is granted; the motion of Carl Creekmore on Count VII is denied;

8. The motions of separate defendant Stephen Adams are granted pursuant to Ark. Stat. Ann. §65-117 (1980 Repl.).

IT IS SO ORDERED.

/s/ H. Franklin Waters  
United States District Judge

6  
No. 91-886

Supreme Court, U.S.

FILED

APR 9 1992

OFFICE OF THE CLERK

In The  
**Supreme Court of the United States**  
October Term, 1991

BOB REVES, ROBERT H. GIBBS,  
and FRANCES GRAHAM,  
As Representatives Of A Class Of Note Holders,  
*Petitioners,*  
v.

ERNST & YOUNG,  
*Respondent.*

On Writ Of Certiorari To The United States  
Court Of Appeals For The Eighth Circuit

JOINT APPENDIX  
VOLUME II  
(Page 226 to End)

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Petition For Certiorari Filed November 27, 1991  
Certiorari Granted February 24, 1992

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UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

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ARTHUR YOUNG & CO.,

Appellant,

v.

BOB REVES; ROBERT H. GIBBS; FRANCES GRAHAM,

Appellees.

---

THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS, and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellants,

v.

ARTHUR YOUNG & CO.,

Appellee.

---

THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

---

THOMAS E. ROBERTSON, JR., etc., et al.

v.

JACK WHITE, et al.

---

THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

---

THOMAS E. ROBERTSON, JR., etc., et al.

v.

JACK WHITE, et al.

---

ROBERT R. CLOAR, Class Counsel,

Appellant,

v.

BOB REVES,

Appellee.

---

Nos. 87-1726WA, 87-1727WA,  
87-1083WA, 87-2533WA and  
88-1014WA

Submitted March 12, 1991  
Decided June 27, 1991

[Reported at 937 F.2d 1310]

Before FAGG and MAGILL,  
Circuit Judges, and SNEED,  
Senior Circuit Judge.  
MAGILL, Circuit Judge.

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THE HONORABLE JOSEPH T. SNEED, Senior Judge, United States Court of Appeals for the Ninth Circuit, sitting by designation.

Arthur Young appeals from the district court's entry of judgment against it after a jury found that the firm had violated both federal and state securities laws.<sup>1</sup> On appeal, Arthur Young argues that the district court erred in (1) certifying the plaintiff class; (2) holding that the financial instruments at issue in this case were securities under Arkansas law; (3) denying its motion for judgment

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<sup>1</sup> This appeal is before us on remand after the Supreme Court reversed our earlier decision that the financial instruments at issue in this case were not federal securities. See Reves v. Ernst & Young, 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990), rev'g Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1990). We had ruled that the instruments were not federal securities under the test from SEC v. W.J. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). See 856 F.2d at 55. The Supreme Court, however, declined to apply the Howey test, and instead applied the Second Circuit's "family resemblance" test, see, e.g., Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976), to conclude that the instruments were securities under federal law. 110 S.Ct. at 952.

notwithstanding the verdict on the state and federal securities claims; and (4) denying its motion for a new trial on the ground that a requested instruction on contribution was not given to the jury. Arthur Young also argues that the damages awarded to the appellees were not supported by the evidence and challenges the district court's awards of attorney fees, costs, and interest to the appellees. On cross-appeal, Reves and Robertson challenge a number of the district court's rulings, including its dismissal of Robertson's breach of contract claim, its granting of summary judgment in favor of Arthur Young on Reves' RICO claim, its crediting of settlement proceeds against the jury's verdict, and its decision on fees for Reves' counsel. We affirm in part and reverse in part.

## I.

## A. The Co-op

The facts of this case involve the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op), which was organized in 1946 and operated in western Arkansas and eastern Oklahoma. Any farmer in the area could become a member, and as a member was entitled to one share and one vote. Each year the Co-op's members elected twelve of their own to serve on a Board of Directors. The Board met monthly to review the Co-op's operations, but delegated actual management of the Co-op to a general manager, whom the Board appointed. In 1952, the Board named Jack White as general manager. White served in that capacity until the Board removed him in mid-1982.

To raise money for its operating expenses, the Co-op sold promissory notes payable to the holder on demand. These

demand notes, while uncollateralized and uninsured, were nonetheless attractive to investors because they paid a higher interest rate than that local financial institutions offered. The Co-op advertised the demand note program in its monthly newsletter as an "Investment Program." The advertisement stated the rate of interest the notes would earn and claimed: "YOUR CO-OP has more than \$11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] Insured but it is . . . Safe . . . Secure . . . and available when you need it. Interest is computed to the day of withdrawal." See, e.g., Joint Appendix (JA) at 1820 (ellipses in original).

### B. The Gasohol Plant

In 1979, the Co-op's general manager, White, joined with entrepreneur Edwin Dooley to finance and construct a gasohol plant. Dooley and White each invested \$125,000 of their own funds and as a result each owned half of the enterprise, which was known as Big D & W Refining and Solvents, Inc. Dooley served as president of the corporation; White was its secretary. Construction of the plant began in June 1979. Four months later, White, financed by a loan from the Citizens Bank & Trust Company (Citizens Bank), purchased Dooley's interest in Big D & W and renamed the company White Flame Fuels, Inc. (White Flame).

Beginning in January 1980, White obtained loans from the Co-op to finance the continued construction and the initial operation of the gasohol plant. White

personally guaranteed these loans. The plant finally began producing gasohol the following April, but was soon beset by problems stemming from the plant's poor design and outside economic factors. White continued to obtain loans from the Co-op; by December 1980, these loans totalled approximately \$4 million.

In September 1980, White was indicted for federal tax fraud. The indictment charges, among other things, that White had engaged in a course of self-dealing with the Co-op and had filed fraudulent tax returns. Also indicted with White was Gene Kuykendall, the Co-op's longtime accountant, who was also White Flame's accountant at this time.

Shortly after the indictment, at a November 12, 1980, Board meeting, White proposed that the Co-op purchase White Flame. The Board agreed and voted to

acquire the company. One month later, however, the Co-op filed a declaratory action against White and White Flame in state court. The complaint had been drafted by White's attorneys, and alleged that on February 15, 1980, White had told the Board that all of White Flame's stock would be transferred to the Co-op in exchange for the Co-op's assumption of White's debts to the Co-op and Citizens Bank.<sup>2</sup> The complaint alleged that in reliance on this agreement, the Co-op invested further sums in White Flame, based on the assumption that it owned the company. The complaint next alleged that White did not transfer the stock as agreed,

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<sup>2</sup> The minutes of the Co-op Board Meeting for February 15, 1980, do not contain any references to the Co-op acquiring the stock of White Flame. JA at 933. In fact, the first reference to the Co-op purchasing White Flames does not occur until the minutes of the November 12, 1980, Board meeting. JA at 1070.

and that the Co-op had not executed a note assuming White's debts to Citizens Bank. Based on these allegations, the Co-op sought a declaratory judgment stating that the Co-op had acquired White Flame on or about February 15, 1980; that the Co-op had assumed Jack White's debt to Citizen's Bank; that all amounts to the Co-op lent to Jack White or White Flame before February 15, 1980, were investments in White Flame; and that Jack White was discharged from any debts to the Co-op relating to White Flame.

Shortly after the complaint was filed, White's attorneys sent the Co-op's attorney, Carl Creekmore, White's answer and a proposed consent decree. Creekmore filed the answer and obtained the state court's approval of the decree on December 19; but the decree was not filed until January 26, 1981. The decree

provided that the Co-op had owned White Flame since February 15, 1980; that the Co-op had assumed White's debt to Citizen's Bank; and that White was discharged from any liability to the Co-op for loans for White Flame. The result of this friendly suit was that White was relieved of over \$4 million of debt and that the Co-op owned White Flame as of February 15, 1980.

### C. The 1981 Audit

Both White and Kuykendall were convicted of tax fraud in January 1981.<sup>3</sup>

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<sup>3</sup> This court affirmed these convictions in United States v. White, 671 F.2d 1126 (8th Cir. 1982). The evidence in the criminal case showed that White had engaged in a course of self-dealing with the Co-op, and that he and Kuykendall had cooked the Co-op books and filed fraudulent tax returns to cover up White's activities. We concluded: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts. . . ." Id. at 1134.

Testifying on White's behalf at the criminal trial was Harry Erwin, the managing partner of Russell Brown and Company, Arkansas' largest accounting firm at that time.<sup>4</sup> Shortly after White's conviction, his lawyer contacted a member of Russell Brown and stated that the Co-op was interested in hiring the firm. In June 1981, Jack White and Kirit Goradia, the Co-op's office manager, met with Erwin and Joe Drozal, another member of Russell Brown. Later that year the Co-op hired Russell Brown to perform the Co-op's 1981 audit. Joe Drozal was named the partner in

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<sup>4</sup> On January 2, 1982, Russell Brown merged with Arthur Young and Company. After the merger, Erwin was placed in charge of Arthur Young's Arkansas practice. Later, Arthur Young and Company became Ernst & Young. For the sake of consistency with the earlier opinions in this case, future references will be to "Arthur Young."

charge; Joe Cabaniss was selected to assist him.

After beginning the 1981 audit process in early 1982, Drozal became aware that there were problems concerning how White Flame should be treated for accounting purposes. In a January 26, 1982,<sup>5</sup> memo, Drozal raised several problems relating to the valuation and acquisition of White Flame. He observed that White Flame's records contained no detailed documentation of cost or expense allocations. Drozal also specifically noted that the Co-op's audited financial statement for 1980 had disclosed the Co-op's full ownership of White Flame, but had not disclosed that the Co-op had forgiven

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<sup>5</sup> Russell Brown had merged with Arthur Young by this time. See supra note 4.

the \$4 million in loans White had personally guaranteed. JA at 1189-1191.

One of Drozal's first tasks in the audit was to determine White Flame's fixed asset value. Drozal realized that he could not rely on the fixed asset value provided for White Flame in the 1980 financial statement because Kuykendall, a convicted felon, had prepared that statement. Therefore, Drozal had to determine it on his own. One way of determining fixed asset value is to add the asset's construction costs to its capitalized expenses. Drozal knew there was a problem with White Flame's reported capitalized expenses, because Jack White had told him that because the plant was only producing at 20% of capacity, they had included only 20% of their production costs as expenses; the remaining 80% of the production costs were added to the fixed asset value of the

plant. Drozal's superior at Arthur Young informed him that only those costs should be added to the plant's value. JA at 1215; 9 Tr. at 236. Drozal's investigation into the treatment of the production costs was limited mainly to talking with Jack White, and reviewing the construction costs and capitalized expenses reported in White Flame's books, which Drozal knew that Kuykendall had prepared. 9 Tr. at 186.<sup>6</sup> Drozal concluded, based primarily on information provided by convicted felons, that the plant's value at the end of 1980 was \$4,393,242.66, exactly the same figure Kuykendall had calculated. JA at 1219. Using this figure as a base, Drozal factored in the 1981 construction costs and

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<sup>6</sup> Kuykendall testified that he fabricated these numbers on White's direction and attempted to cover up the scheme by slightly varying the percentages of costs expensed. 7 Tr. at 258.

capitalized expenses, and concluded that White Flame's 1981 fixed asset value was approximately \$4.5 million. Id.

Once Drozal determined White Flame's fixed asset value, he had to determine how that value should be treated for accounting purposes. This involved examining the circumstances of the Co-op's acquisition of White Flame. If the Co-op had owned White Flame from the beginning of construction in 1979, White Flame's value for accounting purposes would be its fixed asset value, \$4.5 million. If the Co-op had purchased White Flame from Jack White, however, then White Flame's value for accounting purposes would be its fair market value at the time of purchase. Moreover, if the Co-op had purchased White Flame from White, the transaction would have to be closely scrutinized, because White was an officer of the Co-op. Drozal

concluded that the Co-op had owned White Flame from the beginning, and thus that the plant should be valued at \$4.5 million. He based this conclusion on the Co-op's having lent White funds for the plant's construction and operation; that White was supervising the construction and operation; and that the court decree stated that all of the Co-op's loans to White had been investments in the plant. 9 Tr. at 224. Drozal believed that characterizing White Flame as having always been owned by the Co-op reflected "economic reality." Id.

In concluding that the Co-op had always owned White Flame, Drozal ignored a great deal of information suggesting exactly the opposite. For example, although he relied on the court decree's statement that the Co-op's loans to White were really investments, Drozal ignored that part of the decree that stated that

the Co-op had acquired White Flame on February 15, 1980. He ignored the facts that White Flame's tax returns indicated that it was owned by Jack White and Edwin Dooley; that each had initially invested \$125,000 in White Flame; that White had eventually bought Dooley out; that White had always personally guaranteed the loans he received from the Co-op; and that the Co-op's 1979 audit contained no mention of White Flame. Drozal never talked with Dooley, with any 1979 or 1980 Board members, with the Co-op's lawyer, or with the Co-op's previous auditor.

By concluding that the Co-op had always owned White Flame, Drozal was able to avoid applying auditing standards that required a closer look at the actual acquisition and was also able to avoid having to value the plant at its fair market value. The advantage of reaching

this conclusion was clear: Drozal knew that if White Flame were valued at less than \$1.5 million, the Co-op's net worth for 1981 would have been wiped out. 10 Tr. at 41.<sup>7</sup> Drozal also knew that bad news about the Co-op's financial condition could provoke a run on the demand notes and thus deprive the Co-op of its primary source of funds. 9 Tr. at 189.

#### D. The 1981 Audit Report to the Board

On April 22, 1982, Arthur Young<sup>8</sup> presented its 1981 audit report to the Co-

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<sup>7</sup> One expert witness testified at trial that as of December 31, 1981, White Flame was not economically viable, and that its liquidation value was \$500,000 to \$700,000. 4 Tr. at 97. Another expert, who used a more sophisticated appraisal method, testified that White Flame's fair market value at the end of 1981 was between \$444,000 and \$1.5 million. 4 Tr. at 184. Arthur Young did not attempt to rebut this testimony.

<sup>8</sup> See supra note 4.

op's Board of Directors. Arthur Young concluded that with two exceptions, the Co-op's consolidated financial statements fairly presented the Co-op's financial position. The relevant exception stated that Arthur Young had "some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations," JA at 235. The firm explained: "Management has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated factual statements." Id.

The financial statements attached to the audit report listed the Co-op's assets at \$20,869,300. Included in this total was \$4,522,086 for the gasohol plant.

The Co-op's liabilities totaled \$18,246,743, including \$12,164,007 in unredeemed patron demand notes. The Co-op's net worth was \$2,622,557. The financial statement's Note 9 addressed White Flame. The note stated, in relevant part:

Financing of the initial construction and subsequent revisions which totaled approximately \$4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately \$5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging \$100,000 per month) until such time that improvements in market conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investments in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of

a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

JA at 251-52.

Arthur Young did not tell the Board that it concluded that the Co-op had always owned White Flame and thus was able to value the plant at \$4.5 million. 9 Tr. at 227. Nor did it tell the Board that if the Co-op had purchased White Flame, as opposed to owning it from the beginning, there might be a net worth problem. Moreover, Arthur Young never specifically asked the Board or the Co-op's management for projections as to the operations of White Flame. 10 Tr. at 57-58.

#### **E. The 1982 Annual Meeting**

On May 27, 1982, the Co-op held its annual meeting. Approximately 350 people attended. At the meeting, the Co-op

distributed condensed financial statements that purported to convey the economic health of the organization.<sup>9</sup> The condensed financial statement for 1981 stated that the Co-op's assets were \$20,869,300 and that its liabilities were \$18,246,743, leaving the Co-op with a net worth of \$2,622,557. JA at 1231. The statement included White Flame's \$4.5 million asset value in its total assets, but did not include White Flame's \$1.2 million loss. The statement also failed to include any of the information about White Flame's status found in Note 9 of the audit report.

The condensed financial statement also contained the annual meeting's agenda. Listed as giving the financial report was "Harry C. Erwin, C.P.A., ARTHUR YOUNG &

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<sup>9</sup> The Co-op prepared these statements based on Arthur Young's audit report and the accompanying financial statement.

COMPANY." JA at 1241. Also present from Arthur Young was Joe Cabaniss. Erwin received the two condensed financial statements when he arrived at the meeting. He had no advance preparation as to the statement's contents. As he began his presentation, Erwin informed the members that they had condensed statements and that copies of the full audit were at the Co-op's offices. Erwin then started to discuss the condensed statement. The audience soon began asking questions about the acquisition of White Flame and its financial status. When asked how much money White Flame had lost, Erwin responded that it was a separate corporation under federal law. Erwin was also asked how the Co-op had acquired White Flame and responded that he thought the Board had voted to acquire it. During these interchanges, White Flame's \$1.2 million

loss was disclosed to the audience. The meeting began to get very heated, with the audience asking many questions about White Flame and other items in the condensed statement. As the questions increased in both frequency and intensity, Erwin was unable to respond and the Board moved the meeting on.

The result of Erwin's five-minute presentation was that the audience knew that the Co-op owned White Flame and that the plant had \$1.2 million in losses. However, Erwin did not disclose the following: Arthur Young's conclusion that the Co-op had always owned White Flame; that as a result of this conclusion White Flame was valued at \$4.5 million; the material in Note 9 of the full financial statement; that Arthur Young had qualified its audit opinion; that Arthur Young could not satisfy itself as to the proper

carrying value of White Flame; or that a write-down of White Flame to its fair market value would wipe out the Co-op's net worth. 12 Tr. at 112-13.

#### F. The 1982 Audit

The Co-op also hired Arthur Young to perform the 1982 audit. Erwin and Drozal were again Arthur Young's point men. Joe Cabaniss was again selected to work with Drozal and prepared a background memo on the 1982 audit. JA at 1234. The memo classified the Co-op as a "close monitoring client," i.e., a client that might pose some type of risk to Arthur Young. The memo also addressed issues of particular importance for the Co-op's audit. These included the recoverability of the gasohol plant and the condensed financial statements for 1981. As regards the gasohol plant, Cabaniss, before talking to

Drozal, believed its acquisition involved a related party transaction, and hence that the Co-op had not always owned it. Cabaniss also expressed his doubts as to whether the gasohol plant could ever make money. As regards the condensed financial statements, Cabaniss noted:

At the annual meeting the patrons are provided with condensed financial statements. Last year they were given a consolidated balance sheet and a Co-op only income statement which did not reflect the equity in the earnings (loss) of White Flame. We should advise the client of this misleading presentation and find an acceptable manner of presentation.

JA at 1240.

Arthur Young proceeded with the audit. Standard auditing procedures require the auditor to obtain a client representation letter. This letter, drafted by the auditor, but signed by the client's chief executive and financial officers, states that the client's

financial records are accurate and consistent with generally accepted accounting principles. The Co-op's letter for the 1982 audit was signed by Fred Howard, who had replaced Jack White as the Co-op's General Manager. Kirit Goradia, the Co-op's office manager, who essentially functioned as its chief financial officer, did not sign the letter. In the space provided for signing one's name, Goradia wrote: "My only response is attached herewith not as part of this letter." JA at 1245. The attachment stated: "This is to state that during the course of your 1982 audit of books and records of [the Co-op and White Flame], I have not intentionally withheld any information from you." JA at 1246. Goradia told Cabaniss that he did not want to sign the letter because if something happened later, he did not to be accused of wrongdoing. 11 Tr. at

140. Normally, when a company's chief financial officer refuses to sign a representation letter, the auditor is supposed to disclaim the audit opinion or issue an adverse opinion. Id. at 142. Arthur Young, however, did not believe that Goradia had refused to sign the letter, and thus did neither.<sup>10</sup>

#### G. The 1982 Audit Report to the Board

Arthur Young presented its 1982 audit report to the Board on March 7, 1983. The 1982 report was substantially similar to the 1981 report. Arthur Young again stated that "there is some doubt as to the recovery of the investment in [White Flame]

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<sup>10</sup> Arthur Young did not get a signed client representation letter for the 1981 Co-op audit either. When asked about this at trial, Cabaniss responded: "Now, the year before, we thought we had that sucker, and . . . we believed we had it. There was no reason to even think it had been refused." 11 Tr. at 142.

and its continuing operation. Management has not prepared projections and other analyses to assess the potential recovery of this investment." JA at 258. Arthur Young again concluded: "Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statement." Id. Arthur Young's concerns were more fully explained in Note 8 to the financial statement, which was basically the same as the 1981 audit report's Note 9.

The 1982 financial statement reported that the Co-op had assets of \$17,127,986 and liabilities of \$15,741,240, resulting in a net worth of \$1,386,746. The gasohol plant was listed as an asset worth \$4,537,520.

#### H. The 1983 Annual Meeting

The Co-op's 1983 annual meeting was held on March 24 of that year. Sometime before the meeting Goradia and Cabaniss discussed the Co-op's condensed financial statements. Cabaniss told him that Arthur Young's name should not be on the condensed statement because the statement would be misleading without the explanatory notes. Shortly before the meeting Cabaniss and Drozal received a copy of the condensed statement, which stated in boldface letters across the top of the page: "The following financial information was condensed from Arthur Young & Company's Annual Audit." JA at 1248. Drozal and Cabaniss saw that Arthur Young's name was on the statement and that Note 8 was omitted, but said nothing to Goradia. 11 Tr. at 149.

The annual meeting's program stated that the financial report would be

given by Arthur Young. Cabaniss began the financial report by informing the audience that they possessed condensed statements, and that full audit reports were at the Co-op's offices. He knew as he began that the condensed statement was misleading because it did not contain the explanatory notes to the audit. Id. at 150. The presentation lasted three minutes. Cabaniss did not tell the audience that the report was misleading. He did not tell them about Note 8, that Arthur Young was unable to satisfy itself as to White Flame's value, or that if White Flame was written down to its fair market value the Co-op might be in financial trouble. At that time, White Flame's stated value after depreciation was approximately \$3.5 million. The Co-op's net worth was \$1.3 million. If the plant has been written

down to less than \$2.2 million, the Co-op's net worth would have been wiped out.<sup>11</sup>

### I. Bankruptcy

The demand note program was not the Co-op's only source of funds. It also received loans and lines of credit from the Cooperative Finance Association (CFA), which was owned by Farmland, a regional supply cooperative. William Moon, a vice-president of CFA, had informed the Co-op that because of its reliance on demand notes, if the amount of invested notes dropped below \$9.5 million, CFA would cut off the Co-op's line of credit. In the fall of 1983, CFA advanced the Co-op a \$5.78 million line of credit to finance its grain inventory and operations. 3 Tr. at 46. In February of 1984, representatives

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<sup>11</sup> See supra note 5 for the experts' appraisals of White Flame's value.

of the Co-op met with CFA to arrange more financing. 12 Tr. at 12. Later that month the Co-op had a slight run on the demand notes. Id. The Co-op asked CFA for the money on its line of credit to protect itself from further runs. Id. CFA, because total demand note investments had dropped below \$9.5 million, decided not to advance the Co-op any of the \$800,000 the Co-op had remaining on its line of credit. 3 Tr. at 161. The Co-op then filed bankruptcy proceedings on February 23, 1984, to protect itself from a run on the demand notes. 12 Tr. at 13. In the subsequent bankruptcy disclosure statement, which the bankruptcy court approved on September 4, 1984, the Co-op asserted that three factors caused its bankruptcy: (1) ineffective management; (2) using demand notes as the primary source of financing; and (3) the financial problems

of White Flame. AY Ex. 223. The result of the bankruptcy filing was that the demand notes were frozen in the bankruptcy estate, and thus were no longer redeemable at will by the noteholders.

### J. Trial

After the Co-op filed for bankruptcy, it remained as debtor in possession until October of that year, when the bankruptcy court appointed Thomas Robertson as trustee. On February 14, 1985, Robertson, on behalf of the Co-op and certain demand noteholders, filed suit against forty individuals and entities, including members of the Co-op's Board, the Co-op's lawyers, Jack White, Kirit Goradia, Gene Kuykendall, and Arthur Young. On September 27, 1985, the district court certified a class of noteholders consisting of people who purchased demand notes

between February 15, 1980, and February 23, 1984, naming Bob Reves, Frances Graham, and Robert Gibbs the class representatives.<sup>12</sup> Robertson thus no longer represented the Class, but only the Co-op. Before trial, Robertson and the Class settled with all defendants except Arthur Young and Jack White's legal representatives.<sup>13</sup>

Robertson and the Class asserted seven claims against Arthur Young. Four of these claims are relevant to this appeal: (1) Robertson's claim that Arthur Young breached its auditing contract with the Co-op because the firm did not perform its audits in accordance with generally accepted accounting principles and auditing standards; (2) the Class' claim that Arthur

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<sup>12</sup> Future references to the noteholders will be to the "Class."

<sup>13</sup> Subsequent to trial, Robertson and the Class settled with White's lawyers as well.

Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5; (3) the Class' claim that Arthur Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of Arkansas securities law; and (4) Robertson's and the Class' claim that Arthur Young was a material participant in the operation and management of the Co-op, in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68. Arthur Young then cross-claimed against the Co-op's Board of Directors seeking contribution.

Before trial, the district court dismissed Robertson's action for securities fraud and Robertson's and the Class' breach of contract claim. See Robertson v. White

(Robertson I), 633 F. Supp. 954, 974, 976 (W.D. Ark. 1986). The district court also determined before trial that the demand notes were securities under both federal and Arkansas law. See Robertson v. White (Robertson, II), 635 F. Supp. 851, 865 (W.D. Ark. 1986). Arthur Young then moved for summary judgment on Robertson's and the Class' RICO claim, which the district court granted. See Robertson v. White (Robertson III), Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 116 (W.D. Ark. Oct. 15, 1986).

Trial commenced on October 22, 1986, and lasted approximately a month. Robertson's and the Class' witnesses consisted mainly of Board members, accounting, legal, and appraisal experts, and Arthur Young personnel. Arthur Young's witnesses consisted mainly of Board members, a legal expert, and two state

court clerks.<sup>14</sup> After trial, the jury found that Arthur Young had committed both state and federal securities fraud.<sup>15</sup>

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<sup>14</sup> While reviewing the trial transcript after oral argument, we noticed that Board member Larry Heatherington, who was not listed in the transcript's table of contents, did testify. See 2 Tr. at 201-40. We also noticed that at least one part of the trial was not transcribed, namely, the closing argument of counsel for Jack White's law firm. See 16 Tr. at 130-33. Because of our concern with the integrity of the transcript, we requested counsel for Arthur Young and the Class to provide us with a list of the witnesses who testified. Robertson's list, which Arthur Young agreed was accurate, does not include Heatherington. We can only conclude that both parties relied on the transcript's various tables of contents. As a result, we still have reservations about the trial transcript's accuracy. Because apparently neither of the parties share our reservations, we will treat it as accurate.

<sup>15</sup> Although not relevant to the issues on appeal, we note that the jury also found that Arthur Young negligently performed the Co-op's 1981 and 1982 audits, that the Co-op was contributorily negligent, and that Arthur Young had not committed common-law fraud in its performance of those audits.

The jury found that the Class' damages as a result of the fraud totaled \$6,121,652.94.

After the jury returned the verdict, the district court asked the parties to make all motions that might affect the judgment. Responding to these motions in a post-trial memorandum, the district court decided that sums the Class had already received as a result of settlements should offset the jury's verdict. See Robertson v. White (Robertson IV), Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 37 (W.D. Ark. Feb. 5, 1987). The district court also denied Arthur Young's motions for judgment notwithstanding the verdict (JNOV) on the state and federal securities claims. Id. at 49, 61. Finally, the district court rejected Arthur Young's argument that the

court wrongly denied the firm's contribution claim. Id. at 54.

The district court's final judgment as regards Arthur Young was as follows:

Arthur Young is ordered to pay to the Class \$6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claim) and costs, under both state and federal claims, subject to a credit in the amount of \$5,774,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities law claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

Amended Judgment Order, Nos. 85-2044, 85-2096, 85-2155, 85-2259 (W.D. Ark. Apr.

23, 1987). Arthur Young, the Class, and Robertson appealed the various judgments, rulings and orders.

#### K. Subsequent History

This case first came before us in 1988. See Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1988). At that time we reversed the district court's judgment on the threshold issue of whether the demand notes were securities under the federal or Arkansas law, holding that they were not. See id. at 55. Subsequently, the Supreme Court vacated our opinion and reversed, holding that the notes were securities within the meaning of § 3(a)(10) of the Securities Act of 1934, codified at 15 U.S.C. § 78c(a)(10) (1988). See Reves v. Ernst & Young, 494 U.S. 56, 110 S.Ct. 945, 953, 108 L.Ed.2d 47 (1990). On remand, we

now address the plethora of issues the parties originally raised on appeal.

## II.

### A. Class Certification

Arthur Young argues as a threshold matter that the district court erred in certifying the Class. "A district court has broad discretion in determining whether to certify a class, and its determination will not be overturned absent a showing that it abused its discretion." Gilbert v. City of Little Rock, 722 F.2d 1390, 1399 (8th Cir. 1983), cert. denied, 466 U.S. 972 (1984). The Class in this case consisted of all persons who had claims against Arthur Young, as well as the other defendants, "arising out of or based upon the . . . demand notes." Sept. 27, 1985 Certification Order, JA at 1736. Although the record is far from clear on this point,

it appears that the Class was made up of 1,685 people who bought demand notes from February 1980 until the Co-op's bankruptcy in February 1984.<sup>16</sup> The district court decided to certify the Class after reviewing de novo the United States magistrate judge's proposed findings and recommendations. The magistrate judge had concluded, after reviewing ample evidence and considering the relevant factors, that the proposed class of noteholders unquestionably satisfied the requirements of Fed. R. Civ. P. 23. On the record before us, we find no abuse of discretion.

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<sup>16</sup> For the purposes of the federal and state securities fraud claims, the Class consisted of all those who purchased notes after Arthur Young's first audit report to the Board on April 22, 1982.

**B. Robertson's Breach of Contract Claim**

Robertson argues that the district court erred in dismissing his breach of contract of claim against Arthur Young. In Count V of the complaint, Robertson alleged that Arthur Young breached its agreements with the Co-op to conduct the 1981 and 1982 audits in accordance with generally accepted accounting principles and auditing standards. Robertson asked that Arthur Young be held liable for all damages it caused and that it return the fees the Co-op had paid it for services rendered. The district court dismissed Robertson's claim on the ground that the claim alleged misfeasance, i.e., that Arthur Young performed the Co-op's audits in a deficient manner, and that under Arkansas law, misfeasance is a tort, and not a contract, claim. See Oliver v. Bluegrass Resources

Corp., 678 S.W.2d 769, 770 (Ark. 1984); McClellan v. Brown, 632 S.W.2d 406, 407 (Ark. 1982); Morrow v. First Nat'l Bank, 550 S.W.2d 429, 431 (Ark. 1977). We also note that under Arkansas law, the trial court may determine whether an action sounds in tort or contract. See L.L. Cole & Son, Inc. v. Hickman, 665 S.W.2d 278, 281 (Ark. 1984).

Robertson concedes in his brief that his breach of contract claim is based on Arthur Young's misfeasance. He contends, however, that Arkansas' distinction between tort-based misfeasance claims and contract-based nonfeasance claims was not intended to prevent a party with a misfeasance claim from bringing a breach of contract cause of action. Robertson, however, adduces no support for this contention. It is clear that Robertson raises this issue on appeal

because although the jury found that Arthur Young negligently performed the audits, it also found that the Co-op was contributorily negligent, a defense which Robertson admits is fatal to his negligence claim. Robertson and Class Brief at 64.

Because under Arkansas law Robertson's breach of contract claim actually sounds in tort, we conclude that the district court properly dismissed it.

### C. The RICO Claim

The Class argues that the district court improperly granted summary judgment in favor of Arthur Young on its RICO claim. The Class alleged in its complaint that Erwin, Drozal, and Cabaniss conducted or participated in the affairs of the Co-op, committing both mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c), which provides: "It shall be unlawful for

any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity. . . ."

Summary judgment is proper where, viewing the evidence in the light most favorable to the nonmoving party, and giving that party the benefit of all reasonable inferences to be drawn from that evidence, the movant is entitled to judgment as a matter of law. See Agristor Leasing v. Farrow, 826 F.2d 732, 734 (8th Cir. 1987). Viewing the evidence in the light most favorable to the Class, we agree with the district court that, as a matter of law, Arthur Young's involvement with the Co-op did not rise to the level required

for a RICO violation. In Bennett v. Berg, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008, 104 S.Ct. 527, 78 L.Ed.2d 710 (1983), we addressed the nature of the participation required of a RICO defendant before liability is appropriate: "A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." Id. at 1364. Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings. In the course of this involvement it is clear that Arthur Young committed a number of reprehensible acts, but these acts in no way rise to the level of participation in the management or operation of the Co-op.

The Class contends that we should follow the Eleventh Circuit's decision in Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co., 782 F.2d 966 (11th Cir. 1986), where that court stated that it "is not necessary that a RICO defendant participate in the management or operation of the enterprise." Id. at 970. We are aware of the inconsistencies between the circuits regarding the necessary level of participation for RICO liability. See Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639, 913 F.2d 948, 952-55 (D.C. Cir. 1990) (en banc) (reviewing the varied approaches to the participation requirement taken by the Second, Fourth, Fifth, Seventh, Eighth and Eleventh Circuits and adopting the Eighth Circuit's standard), cert. denied, \_\_\_\_ U.S. \_\_\_\_, 111 S.Ct. 2839, 115 L.Ed.2d 1007 (U.S. June 17, 1991). But until the

Supreme Court rejects our standard or this court en banc overrules Bennett, we are bound to follow that decision. Therefore, we conclude that the district court properly granted summary judgment in favor of Arthur Young on the Class' RICO claim.

#### **D. Demand Notes and Arkansas Law**

Arthur Young next argues that the district court erred in holding that the Co-op's demand notes were securities under Arkansas law. We review de novo the district court's ruling on this state law issue. See Salve Regina College v. Russell, 111 S.Ct. 1217, 1221 (1991). The district court based its conclusion on three considerations: the legislative history of Arkansas' securities laws; Arkansas' broad, protectionist approach to securities regulation; and federal case law. See Robertson II, 635 F. Supp. at

855-65. As regards the third consideration, another Arkansas federal court has observed that "[t]he Arkansas definition of a security is essentially identical to the definition under federal securities laws." See First Fin. Fed. Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp., 652 F. Supp. 471, 475 (W.D. Ark.), aff'd, 834 F.2d 685 (8th Cir. 1987). We have carefully considered the district court's comprehensive legal analysis of this issue, and conclude, based on this analysis and the Supreme Court's decision that the demand notes are securities under federal law, that the demand notes are also securities under Arkansas law.

#### **E. The State Securities Fraud Claim**

Arthur Young next argues that the district court erred in denying its motion for JNOV on the state securities fraud

claims. In reviewing a district court's denial of a motion for JNOV, we

must consider the evidence in the light most favorable to the prevailing party, assume that the jury resolved all conflicts of evidence in favor of that party, assume as true all facts which the prevailing party's evidence tended to prove, [and] give the prevailing party the benefit of all favorable inferences which may reasonably be drawn from the facts.

Atlas Pile Driving Co. v. DiCon Fin. Co., 886 F.2d 986, 989 (8th Cir. 1989). We will affirm the denial, "if in light of the foregoing, reasonable jurors could differ as to the conclusion that could be drawn from the evidence." Id.

Arthur Young argues that even accepting all of the Class' allegations as true, it cannot be held liable for securities fraud under Arkansas law. Under Arkansas law, civil liability for securities fraud exists for any person who

[o]ffers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Ark. Stat. Ann. § 23-42-106(a)(1)(B) (1987).<sup>17</sup> Arthur Young contends that it cannot be held liable under § 106(a) because it was neither an offerer or seller of securities. The Class does not contest this point, arguing that Arthur Young was not charged with primary liability under § 106(a), but with secondary liability under

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<sup>17</sup> At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(a)(2) (1980 Replacement). Section 67-1256 was modeled after § 410 of the Uniform Securities Act. Section 410(a)(1)(2) of the Uniform Act in turn, was modeled after § 12(2) of the Securities Act of 1933, codified at 15 U.S.C. § 771(2) (1988).

Ark. Stat. Ann. § 23-42-106(c), which provides:

Every person who controls a seller liable under subsection (a) of this section . . . ; every partner, officer, or director of such a seller or purchaser; every person occupying a similar status or performing a similar function; every employee of such a seller or purchaser who materially aids in the sale; and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with, and to the same extent as, the seller or purchaser, unless the nonseller or nonpurchaser who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.<sup>18</sup>

Section 106(c) expressly creates two types of secondary liability for securities fraud, control person liability and aiding and abetting liability. See, e.g., Hogg v. Jerry, 773 S.W.2d 84, 87

<sup>18</sup> At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(b) (1980 Replacement).

(Ark. 1989). In denying Arthur Young's motion for JNOV, the district court reasoned that because Arthur Young "originated" the material statements that were used to sell the demand notes, "it obviously had the power to 'control' the content of those statements." Robertson IV, slip op. at 47. Arthur Young contends that the proper test for control person liability is whether the defendant "actually participated in (i.e., exercised control over) the operations of the corporation in general," and if so, whether the defendant "possessed the power to control the specific transaction or activity upon which the primary violation is predicated." See Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985) (emphasis in original), cert. denied sub nom. Bankers Trust Co. v. Metge, 474 U.S. 1072 (1986). We note in passing that Arthur Young

certainly did not direct the Co-op's operations. We need not determine, however, whether the test for control person liability under 15 U.S.C. § 77o (1988) we established in Metge also applies to the Arkansas securities laws. Rather, we believe that the other type of secondary liability for securities violations, aiding and abetting liability, applies to the facts of this case.

Section 106(c) explicitly makes liable for securities fraud any employee of the seller who materially aids in the sale of the security. As the Alabama Supreme Court has observed concerning its version of the same statute:

A third category under the Alabama Act that goes beyond the comparable federal provision enumerates persons who cannot properly be considered control persons, such as employees of the seller or broker-dealers or agents who may have participated in the sale. The latter persons are included on the basis of what may be

considered an express statutory aiding and abetting theory, since the employee, broker-dealer or agent must have "materially aid[ed] in the sale." Therefore, to hold a person liable a plaintiff need not show any active connivance or participation by the alleged control person, except in the case of an employee, broker-dealer, or agent; all he need do is establish the defendant's status, either as a controlling person, a partner, or an occupant of some other statutory classification . . . plus the fact of the seller's liability. The defendant then is left with only one defense . . . . He may show that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the seller's liability is alleged to exist.

Foster v. Jesup & Lamont Sec. Co., 482 So. 2d 1201, 1207 (Ala. 1986) (quoting Rediker, Alabama's "Blue Sky Law"--Its Dubious History and Its Current Renaissance, 23 Ala. L. Rev. 667, 714 (1971)).<sup>19</sup>

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<sup>19</sup> The Alabama statute provides:

Every person who directly or indirectly controls a seller liable under subsection (a) of this section, every partner, officer or

The district court, in denying Arthur Young's motion for JNOV on this issue, did not discuss § 106(c), but instead relied on an amalgam of rather tenuous theories. See Robertson IV, slip op. at 40-48. Nonetheless, we believe the district court's instruction to the jury on the state securities claim fulfilled the

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director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with and to the same extent as the seller, unless the nonseller who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

Ala. Code § 8-6-19(b) (1984), quoted in Foster, 482 So. 2d at 1208 n.22. Section 8-6-19(b), like the Arkansas statute, is based on § 410 of the Uniform Securities Act. See id. at 1207.

requirements of § 106(c). The district court instructed the jury that to hold Arthur Young liable for violating Arkansas' blue sky law, it had to find: (1) that the Co-op sold demand notes to the Class by means of untrue statements or omissions of material facts; (2) that the Class did not know of the untrue statements or the omissions;<sup>20</sup> (3) that the untrue statements or the omissions "originated" with Arthur Young; (4) that Arthur Young knew that the statements were being communicated to the Class, and that they were material, "being of the kind and nature that a reasonable person would foreseeably rely on them;" and (5) that Arthur Young knew the statements

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<sup>20</sup> Arthur Young also contends that the Class did not satisfy its burden of proof that it did not know of the omissions. That, however, is the theory behind the Class' securities claim in general. We believe that on the facts of this case, a sufficient showing was made.

were false when it made them. 18 Tr. at 79-80. Thus, the jury could only hold Arthur Young liable if it concluded that Arthur Young originated the untrue statements or omissions, knew that the statements were communicated to the Class, and knew that the Class would rely on them to purchase the demand notes; in other words, that Arthur Young "materially aided" in the sale of the demand notes. We note that the trial evidence provides ample support for the jury's verdict against Arthur Young on this issue.

Because we believe this instruction generally comports with the requirements of § 106(c), the only issue that remains is whether the district court's failure to instruct the jury that Arthur Young was not liable if it did not know, and in the exercise of reasonable care could not have known, of the existence

of the facts by reason of which the Co-op's liability was alleged to exist, constitutes a ground for reversal. See Ark. Stat. Ann. § 23-42-106(c). We think not. The district court instructed the jury not to hold Arthur Young liable unless the firm "originated" the linchpin of the securities fraud. By establishing such a high threshold for liability, the district court, perhaps unintentionally, made sure that the jury would not hold Arthur Young liable if it did not know of the facts giving rise to the fraud. Therefore, that no specific instruction was given on this defense does not constitute a ground for reversal because the instruction that was given achieved the same result.

In sum, we believe that Arkansas law does provide for secondary liability for securities fraud in this case. The district court's instructions on this

issue, while not precisely comporting with the requirements of § 23-42-106(c), did generally meet those requirements. As a result, the jury could have held Arthur Young liable only if it concluded that the firm materially aided in the sale of the demand notes. Thus, we conclude that the district court properly denied Arthur Young's motion for JNOV on this issue.

#### F. The Rule 10b-5 Claim

##### 1. Background

Arthur Young next argues that the district court erred in denying its motion for JNOV on the federal securities claim because it was entitled to judgment as a matter of law. Rule 10b-5<sup>21</sup> provides:

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<sup>21</sup> Rule 10b-5 implements 15 U.S.C. § 78j (1988), which states in pertinent part:

It shall be unlawful for any person, directly or indirectly, by

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

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the use of any means or instrumentality of interstate commerce or of the mails . . .

(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . .

The Supreme Court has referred to § 10b as a "'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.'" See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (bracketed material in original).

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1990). The purpose behind Rule 10b-5 is to "transcend the gaps and limits of the common law actions available to securities traders injured by false representations or failures to disclose." R. Clark, *Corporate Law* 310 (1986). The rule has been referred to as "a judicial oak which has grown from little more than a legislative acorn," see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (Rehnquist, J.), and as "a horse of dubious pedigree but very fleet of foot." See L. Loss, *Fundamentals of Securities Regulation* 820 (1983). Our review of the case law has brought home the accuracy of these characterizations.

The essential components of a Rule 10b-5 claim are scienter, causation, and damages. See Abbey v. Control Data Corp.

(In re Control Data Sec. Litig.), No. 90-5107, slip op. at 4 (8th Cir. May 10, 1991). Primarily at issue in this case is causation, which has two elements. To satisfy the first element, a plaintiff must prove that the allegedly fraudulent acts caused the plaintiff to purchase the securities. See Harris v. Union Elec. Co., 787 F.2d 355, 366 (8th Cir.), cert. denied, 479 U.S. 823 (1986). We have variously characterized this showing as a type of "causation in fact," see Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409 (8th Cir. 1979), "but for causation," see Harris, 787 F.2d at 366, "reliance," see Austin v. Loftsgaarden, 675 F.2d 168, 177 (8th Cir. 1982), or as satisfying Rule 10b-5's "in connection with the purchase or sale of any security" requirement. See Forkin v. Rooney Pace, Inc., 804 F.2d 1047, 1049 (8th

Cir. 1986).<sup>22</sup> In the lingua franca of Rule 10b-5 cases, however, this showing is usually referred to as "transaction causation." See e.g., Wilson v. Ruffa & Hanover, P.C., 844 F.2d 81, 86 (2d Cir. 1988); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir.), cert. denied, 488 U.S. 926 (1988); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 35 n.5 (D.C. Cir. 1987); see also Merritt, A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Right to Fit the Wrong, 66 Tex. L. Rev. 469, 471-72 (1988) (discussion transaction causation). Thus, for consistency's and simplicity's sake, we

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<sup>22</sup> Indeed, the district court instructed the jury in this case: "The 'in connection with' aspect of this element is satisfied if you find that there was some substantial nexus or relation between the allegedly fraudulent conduct and the sale or purchase of securities." 18 Tr. at 73.

will refer to this showing as "transaction causation."

To satisfy the second causation element the plaintiff must prove that the allegedly fraudulent acts caused the plaintiff's economic harm. See Austin, 675 F.2d at 178. As with transaction causation, we have characterized this showing as a type of "causation in fact," see Vervaecke v. Chiles, Heider & Co., 578 F.2d 713, 719 (8th Cir. 1978); St. Louis Union Trust Co. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040, 1049 (8th Cir. 1977), cert. denied, 435 U.S. 925 (1978), although the two showings are analytically distinct. Again, endeavoring to maintain some consistency with our sister circuits, see, e.g., Bastian v. Petren Resources Corp., 892 F.2d 680, 683-84 (7th Cir.), cert. denied, 110 S. Ct. 2590 (1990); Wilson, 844 F.2d at 55; Elias

v. Arthur Andersen & Co. (In re Financial Corp. of Am. Shareholder Litig.), 796 F.2d 1126, 1130 (9th Cir. 1986), and the commentators, see, e.g., Merritt, 66 Tex. L. Rev. 469 passim, we refer to this showing as "loss causation."

## 2. Transaction Causation

With regard to causation, Arthur Young first argues that it is entitled to judgment as a matter of law because no one from the Class testified that they heard Arthur Young's presentation at the Co-op's annual meetings and thereafter bought demand notes. Because the Class' claim was based on Arthur Young's misrepresentations at the annual meetings, the firm contends, the Class had to prove that it relied on those misrepresentations in buying the demand notes. See Vervaecke, 578 F.2d at 717. The Class' failure to offer evidence

of transaction causation, Arthur Young concludes, is fatal to its Rule 10b-5 claim.

The Class responds that because its claim is based primarily on Arthur Young's nondisclosure of material information about the Co-op's financial health, it is entitled to a rebuttable presumption of transaction causation. In making this argument, the Class relies on a long line of cases in which this court has stated that where the defendant's alleged conduct involves primarily a failure to disclose, the plaintiff need not prove transaction causation; instead, such causation will be inferred if the withheld information was material. See Barnes v. Resource Royalties, Inc., 795 F.2d 1359, 1367 (8th Cir. 1986), cert. denied sub nom. McPherson v. Barnes, 110 S. Ct. 1129 (1990); Harris, 787 F.2d at 366; Austin,

675 F.2d at 177; St. Louis Union Trust Co., 562 F.2d at 1048-49. The inference is not conclusive; rather, it creates a rebuttable presumption of transaction causation. See, e.g., Barnes, 795 F.2d at 1367.

**a. Nature of the Class' Claim**

The sub-issue thus becomes whether the Class' Rule 10b-5 claim is based on misrepresentation or nondisclosure. The district court concluded that the Class' claim was based on a nondisclosure theory and instructed the jury accordingly.<sup>23</sup>

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<sup>23</sup> The district court instructed the jury:

The second element which the Class must prove by a preponderance of the evidence is that the Class justifiably relied upon the defendant's statements or conduct. However, in order to satisfy this element, the Class need not prove that the Class actually relied on defendant's conduct. Rather, plaintiff's [sic] can satisfy his burden if he proves that the

This is a conclusion of law that we review de novo. See Vervaecke, 578 F.2d at 718 n.2. Of great relevance in determining this issue is how a claimant pleads its Rule 10b-5 claim: "While [plaintiff] tries to present this case to us as a case involving primarily nondisclosure, we have carefully examined the pleadings and do not view it as such." See id. at 717. In this case, the Class' complaint states its nondisclosure theory: "Defendants . . . are liable because the accountants knew that they were inducing or causing the purchase of demand notes through concealment of the Co-op's financial condition." JA at 51 (emphasis added). We recognize that there is some analytical

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defendant sought to be charged omitted to state a fact to him, and that the omitted fact was material.

18 Tr. at 74-75.

difficulty in separating misrepresentations from nondisclosures, because misrepresentations often result from the withholding of some material fact. On the facts and the pleadings in this case, however, we believe that the district court properly characterized this claim as one involving primarily nondisclosure.

Because the Class' claim was premised on a theory of nondisclosure, the Class was entitled to a rebuttable presumption that transaction causation had been shown. Although Arthur Young had notice in the early stages of this action that the Class was going to use the nondisclosure-based rebuttable presumption, see Proposed Report and Recommendation on Class Certification, JA at 1454 ("Reliance is unlikely to be an issue in a nondisclosure case . . . ."), it did not attempt to rebut the presumption. For

Arthur Young to argue now that it was entitled to judgment as a matter of law because the Class did not show transaction causation is a bold move indeed.<sup>24</sup>

#### b. Duty to Disclose

Arthur Young raises a second sub-issue with regard to transaction causation, namely, that it could only be held liable for nondisclosure if it had a duty to disclose, and that because it had no such duty, it was entitled to judgment as a matter of law. In making this argument, Arthur Young relies on Chiarella v. United States, 445 U.S. 222 (1980), where the

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<sup>24</sup> We note that the district court failed to instruct the jury that the presumption of transaction causation (reliance) was rebuttable. However, Arthur Young has not raised this as a ground for reversal), which is understandable in light of its failure even to attempt to rebut the presumption.

Supreme Court stated that nondisclosure is actionable under Rule 10b-5, but that "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence." Id. at 230.<sup>25</sup> Arthur Young argues that because there is no evidence that it had contacts with the Class, it had no relationship with the Class, and that it thus was under no duty to disclose.

A relationship for purposes of Rule 10b-5 liability, however, requires neither a "physical presence nor face to

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<sup>25</sup> Before Chiarella, this court had stated that the duty to disclose came from Rule 10b-5 itself. See Myzel v. Fields, 386 F.2d 719, 740 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). This statement is no longer accurate. See, e.g., Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986) ("[T]his duty does not come from § 10(b) or Rule 10b-5; if it did the inquiry would be circular. The duty must come from a . . . relation outside securities law.").

face conversation." See SEC v. Washington County Util. Dist., 676 F.2d 218, 223 (6th Cir. 1982) (footnote omitted). Rather, whether a relationship exists that gives rise to a duty to disclose depends on the circumstances of the individual case. See Roberts v. Peat, Marwick, Mitchell & Co., 857 F.2d 646, 653 (9th Cir. 1988) (per curiam), cert. denied, 110 S. Ct. 561 (1989); Jett v. Sunderman, 840 F.2d 1487, 1493 (9th Cir. 1988); Winton Third Oil & Gas Drilling Partnership v. Federal Deposit Ins. Corp., 805 F.2d 342, 347 (10th Cir. 1986), cert. denied, 480 U.S. 947 (1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1043 (11th Cir. 1986), cert. denied, 480 U.S. 946 (1987); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied sub nom. Walter E. Heller & Co. v. First Va. Bankshares, 435 U.S. 952 (1978). The Fifth, Ninth, and

Eleventh Circuits have established a number of factors to be used in evaluating those circumstances, including (1) the parties' relative access to the information; (2) the benefit the defendant derives from the sale of the securities; (3) the defendant's awareness of the plaintiff's reliance on the defendant in making investment decisions; and (4) the defendant's role in initiating the sale. See Jett, 840 F.2d at 1493<sup>26</sup> Rudolph, 800 F.2d at 1043; First Va. Bankshares, 559 F.2d at 1314; see also In re National Smelting of N.J., Inc. Bondholders Litig., 722 F. Supp. 152, 170-

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<sup>26</sup> In Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (en banc), cert. denied, 111 S. Ct. 1621 (1991), the Ninth Circuit stated that it would no longer use the "flexible duty" test. Id. at 1570. However, this statement was limited to the scienter element of a Rule 10b-5 violation and thus appears not to alter the duty to disclose analysis.

71 (D.N.J. 1989) (applying the same analysis). In addition, the Eleventh Circuit also considers (5) the extent of the defendant's participation in the fraud. Rudolph, 800 F.2d at 1043.

Therefore, we must examine the facts of this case in light of these factors to determine whether a relationship giving rise to a duty to disclose existed between the Class and Arthur Young at the time of the nondisclosure. The first factor, the parties' relative access to information, supports a duty to disclose: Arthur Young was the source of some of the information that was not disclosed, e.g., the assumption about the Co-op's always having owned White Flame, and was aware of the critical information that if White Flame was given a lower value, the Co-op's

net worth would be wiped out.<sup>27</sup> The second factor, the benefit the defendant derives from the sale, supports a duty to disclose in this case, but only weakly. Arthur Young did benefit from the sale of the demand notes, but only because the Co-op was a client and the demand notes were the Co-op's primary source of financing. This sort of indirect benefit, however, does not count for much.

The third factor, the defendant's awareness that the plaintiff relied on it in making investment decisions, also supports a duty to disclose here. Arthur Young knew that the demand notes were a

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<sup>27</sup> Although this factor supports a duty to disclose in this case, we do not afford it great weight in light of dicta found in the Chiarella decision: "A duty arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market." 445 U.S. at 231-32 n.14.

risky source of financing and that bad news could cause a run on the Co-op. Conversely, Arthur Young must also have known that good news would ensure that people continued to buy demand notes. It is important to understand the nature of the Co-op's demand note clientele. The Class consists primarily of farmers, pensioners, and others who lived in and around Van Buren, Arkansas. Many of the Class members invested all of their savings in the Co-op's demand note program. These were not sophisticated investors. Thus Arthur Young had to know that good news about the Co-op's finances, or even the lack of bad news, would cause people to invest in the Co-op. As the Fifth Circuit has observed: "[T]he danger of misleading the public through a false opinion is obvious. A public accountant performs an important public function and must be aware

that the public places great faith in the probity of its opinions." Fine v. American Solar King Corp., 919 F.2d 290, 298 (5th Cir. 1990), petition for cert. filed, 59 U.S.L.W. 3615 (U.S. Mar. 4, 1991) (No. 90-1372), motion to defer consideration of petition granted, 59 U.S.L.W. 3769 (U.S. May 13, 1991).

Although the fourth factor, the defendant's role in initiating the transaction, does not support a duty to disclose because Arthur Young played no active role in the purchase of the demand notes, the final three factors do. The fifth factor, the extent of the defendant's knowledge, clearly weighs in favor of a duty to disclose in this case because it is undisputed that Arthur Young knew everything the Class wishes had been disclosed. The sixth factor, the significance of the nondisclosed matters,

also obviously supports the duty to disclose. Finally, the seventh factor, the extent of the defendant's involvement, supports the duty as Arthur Young's involvement ranged from its conclusion about the acquisition of White Flame to its valuation of the plant to its actions at the Co-op's annual meetings. Therefore, based on these factors, Arthur Young had a relationship to the Class such that the Class had placed its "trust and confidence," Chiarella, 445 U.S. at 232, in the firm.

Arthur Young argues that it would be unfair to impose a duty to disclose on it in this case because it had no means to satisfy that duty. This claim is preposterous. Arthur Young knew the condensed financial statements were misleading because they did not discuss the problems with White Flame. At the annual

meetings Arthur Young could have said something, but simply chose not to. We wonder how difficult it would have been for Arthur Young, at either of the annual meetings, to inform the audience that there was something suspicious about the acquisition of White Flame, that Arthur Young had concluded that the Co-op had always owned the plant and relied on Kuykendall's numbers in valuing it, and that if White Flame were carried at a lower value, the Co-op might have a negative net worth. Given the importance of that information, the nature of the Co-op and the people who invested in it, the Co-op's location in a relatively rural area, and the interest of local news organizations in the Co-op's affairs, it seems sure that the Class would have heard what it now dearly wishes it had heard. Thus, Arthur Young could have satisfied its duty with perhaps

two of the ten minutes it used to address the annual meetings in 1982 and 1983.<sup>28</sup>

Based on the unique facts and circumstances of this case, we hold that Arthur Young's relationship with the Class was such that it had a duty to disclose.

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<sup>28</sup>Arthur Young also relies on a line of Seventh Circuit cases for the proposition that it had no duty to disclose. See DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir.), cert. denied, 111 S. Ct. 347 (1990); Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322 (7th Cir. 1989); LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928 (7th Cir. 1988); Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986). These cases, however, do not apply to the case at hand because they all involve claims for aiding and abetting Rule 10b-5 violations against accounting firms that did not blow the whistle on their clients, as opposed to the primary Rule 10b-5 liability asserted here. See, e.g., Latigo Ventures, 876 F.2d at 1327 ("It is not the law that whenever an accountant discovers that his client is in financial trouble he must blow the whistle on the client for the protection of investors . . . ."). Moreover, those cases feature vastly different factual circumstances and procedural postures. We do not believe these cases direct the result here.

Because of this duty to disclose, the Class was entitled to a rebuttable presumption of transaction causation. As Arthur Young did not attempt to rebut the presumption of transaction causation, the district court did not err in refusing to grant Arthur Young's motion for JNOV on the ground that the Class had not shown transaction causation.

### 3. Loss Causation

Arthur Young next argues that the district court erred in not granting its motion for JNOV on the ground that the Class failed to prove loss causation, that is, that Arthur Young's nondisclosure caused the Class' economic harm. See supra II.G.1. Arthur Young argues that the Class' economic harm was caused by the Co-op's bankruptcy, which, in turn, was directly precipitated by CFA's refusal to

honor the Co-op's line of credit. Thus, Arthur Young argues, there is no loss causation because the bankruptcy was unrelated to the alleged fraud. Arthur Young's contention, while of some merit, is ultimately unavailing because of this Court's broad test for loss causation. In our most recent Rule 10b-5 opinion, Chief Judge Lay observed: "Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus' between [the defendant's] improper conduct and plaintiff's losses. . . . Traditional tests of proximate cause derived from tort principles are very much germane." See Abbey v. Control Data Corp. (In re Control Data Corp. Sec. Litig.), No. 90-5107, slip op. at 7 (8th Cir. May 10, 1991) (citations

omitted).<sup>29</sup> Thus, all the Class needed to show was that the Co-op's bankruptcy was somehow "related" to Arthur Young's

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<sup>29</sup>The district court's instruction on this issue was based on a theory of proximate cause:

The fourth element that the trustee must establish by a preponderance of the evidence is that the defendant's conduct was the proximate cause of the injury to the plaintiff.

In order for an act or omission to be considered a proximate cause of the injury, it must be a substantial factor in causing the damage, and the injury must have been either a direct result or a reasonable probable consequence of the act or omission.

In order to satisfy this element, the plaintiff need not prove that the defendant's conduct was the only cause of the plaintiff's injury. It is sufficient if you find that the actions of the defendant were a substantial and significant contributing cause to the injury which the plaintiff suffered.

See 18 Tr. at 78.

nondisclosures. See St. Louis Union Trust Co., 562 F.2d at 1049.

We believe the Class' evidence was sufficient on this issue. The Class showed that the Co-op would have had serious financial problems in 1981 had Arthur Young disclosed the information about White Flame. We are unable to say that Arthur Young's nondisclosure was unrelated to the Co-op's eventual bankruptcy.

Moreover, we note that one of Arthur Young's own exhibits refutes its contention that its nondisclosure was unrelated to the Co-op's bankruptcy. That exhibit contains the bankruptcy court's order approving the Co-op's disclosure statement to its creditors, along with the statement itself and the bankruptcy plan of reorganization. The disclosure statement, which the Co-op's bankruptcy counsel prepared, states that there were three

reasons for the bankruptcy filing: problems with the Co-op's management, the Co-op's reliance on demand notes for financing, and most importantly for our analysis, the financial problems associated with White Flame. See AY Ex. 223.

Because a reasonable jury could have found that Arthur Young's nondisclosure contributed to the Co-op's bankruptcy, and hence the Class' injury, we hold that the district court did not err in refusing to grant Arthur Young's motion for JNOV on the issue of loss causation.

#### 4. Scheme to Defraud

Finally, Arthur Young argues that the district court erred because its instructions to the jury on the Rule 10b-5 claim were based on a scheme to defraud theory, that this theory is synonymous with a conspiracy theory, and that the district

court had already determined that there was no conspiracy in this case. We do not believe that the limited references to scheme to defraud constitute reversible error in this case. Reading the instructions as a whole, see Smith v. Hussman Refrigerator Co., 619 F.2d 1229, 1245 (8th Cir.) (en banc), cert. denied, 449 U.S. 839 (1980), it is clear both that the jury was not required to find any sort of conspiracy, and that Arthur Young's conduct satisfied the elements of a Rule 10b-5 violation.

#### 5. Conclusion

In sum, the district court properly refused to grant Arthur Young's motion for JNOV on the Class' Rule 10b-5 claim. As is apparent, the key to our resolution of this issue is the conclusion that Arthur Young had a duty to disclose

material information to the Class. This duty was a necessary prerequisite to the Class' nondisclosure theory and the resulting shift in the burden of proof on the issue of transaction causation. Arthur Young has argued vehemently against the existence of such a duty, claiming, among other things, that finding such a duty will increase the costs of all audits and lessen the amount of accounting oversight because firms will be unwilling to pay the higher prices. This policy-based rationale, however, does not comport with the law, nor with common sense. It must be kept in mind that whether or not a duty exists will be determined on a case-by-case basis, and that the duty to disclose imposed in this case was based on unique facts and circumstances. We certainly doubt that other accounting firms will engage in the type of conduct that Arthur Young did in

this case. More particularly, we hope that Arthur Young will not.

#### **G. Arthur Young's Contribution Claim**

Arthur Young next argues that the district court erred in not submitting its contribution claim against the Co-op's Board of Directors to the jury. Arthur Young contends that it submitted a contribution instruction on the securities claims, but that the district court did not offer any such instruction. The district court, in denying Arthur Young's motion for a new trial on this issue, concluded that Arthur Young did not make a specific objection at trial concerning the court's failure to instruct on the contribution claim, and moreover that the instruction Arthur Young allegedly tendered incorrectly stated the law. Robertson IV, slip op. at 37.

After reviewing the record, we conclude that the district court properly denied Arthur Young's motion for a new trial on this issue. On November 12, 1986, the district court informed counsel for all parties that they were to meet with his law clerks off the record and discuss the pros and cons of the proffered instructions, and that later all counsel would have an opportunity to go on the record in relation to the instructions. 16 Tr. at 201-03. On November 14, the district court conducted these on-the-record proceedings. At that time the district court stated:

We are aware, in some detail, of the position of each of you, in relation to the issues that ought to be presented. What I'd like for you to do, because I understand that's all you need to do, in order to make your record to the Court of Appeals, is to tell me which of these instructions you think are wrong or should not be given, what additional instructions you think ought to be given and, very briefly, why. . . . Just do what you know is necessary,

so that the Court of Appeals can see that you've made your record in relation to those instructions.

17 Tr. at 6. Counsel for Arthur Young objected to the proposed instructions as to contribution on Robertson's negligence claim against Arthur Young. Id. at 25. Counsel, however, mentioned nothing about contribution on the Class' securities claims. Id. at 18-26. The next day, counsel was given another opportunity to go on the record about the instructions after the district court read them to the jury. Counsel raised several new objections at this point, but again mentioned nothing about contribution against the Board on the Class' securities claims. 18 Tr. at 92-94.<sup>30</sup>

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<sup>30</sup>Our conclusion that Arthur Young did not object to the failure to instruct based on our review of the transcript is also supported by Arthur Young's failure to indicate in its briefs where it objected.

Fed. R. Civ. P. 51 states: "No party may assign as error . . . the failure to give an instruction unless that party objects thereto before the jury retires to consider its verdict, stating distinctly the matter objected to and the grounds of the objection." The purpose of Rule 51 is to "compel litigants to afford the trial court an opportunity to correct any error in the instructions and also to prevent the losing party from obtaining a new trial through relying on a possible error in the original trial." Johnson v. Houser, 704 F.2d 1049, 1051 (6th Cir. 1983) (per curiam). As Wright and Miller have observed: "This purpose is well understood by the courts and the rule is applied in light of it. The necessity of a retrial is avoided when, by design or through sheer neglect, the losing party fails to make objection at the proper time." 9 C. Wright

& Miller, Federal Practice and Procedure § 2551 (1971) (footnotes omitted).

We note that Arthur Young might have had a colorable claim for contribution against the directors. Ark. Stat. Ann. § 23-42-106(c) specifically provides for contribution in the case of secondary liability for securities fraud. However, "[e]rror in the instructions not properly objected to is waived unless the error is plain error in the sense that a miscarriage of justice would otherwise result." Johnson, 704 F.2d at 1051. The plain error exception is limited to the "exceptional case, in which error has affected seriously the fairness, integrity or public reputation of judicial proceedings." Id. at 1052. This is not such an exceptional case, and no miscarriage of justice has occurred, because it is clear that much of

the blame for the fraud in this case is placed properly on Arthur Young.

Putting this in some perspective, we note that the jury received 100 instructions in this case; eighty pages in the trial transcript are devoted to the district court's reading of those instructions to the jury. Id. at 4-84. Arthur Young now complains about the district court's failure to offer one instruction, when the firm had several days' notice as to when the instructions could be objected to, and at least two opportunities specifically to object to those instructions. Arthur Young could have objected to the failure, but did not. We conclude that the locus of the responsibility for the failure to instruct lies with Arthur Young, and not the district court, and thus that the district

court properly denied the firm's motion for a new trial.

## H. The Damages

### 1. Damages Evidence

Arthur Young next raises several issues concerning the damages awarded the Class. As an initial matter, Arthur Young challenges the competency of the Class' evidence on damages. That evidence consisted of a computer run showing the demand notes purchased between April 22, 1982, when Arthur Young made its first presentation to the Board, and February 23, 1984, when the Co-op declared bankruptcy and the demand notes were frozen in the bankruptcy estate. The computer run showed that the notes purchased between those dates totaled \$6,121,652.94. The jury awarded the Class exactly this amount after

holding Arthur Young liable for state and federal securities fraud.

Arthur Young raises two main arguments with respect to the competency of the computer print-out. First, it contends that the print-out included the demand notes which had been redeemed within the ninety days before the Co-op's bankruptcy. Arthur Young argues that because these Class members received payment in full on their notes, they have no damages. The Class argues that these noteholders were included because their redemptions would be revoked as preferential transfers, ostensibly under 11 U.S.C. § 547 (1988). Therefore, the Class argues, these "preference" noteholders "were included in the Class as if they actually held notes." Robertson and Class Brief at 43. Robertson and the Class argue that there was no point in forcing Robertson to prosecute actions

against all of these individuals if Arthur Young was found liable, because Robertson would just seek a decree to stand in shoes of those noteholders against Arthur Young.<sup>31</sup>

Arthur Young's second argument is that the \$6.1 million figure for the total number of demand notes sold between April 22, 1982 and February 23, 1984, also includes notes that were bought before April 22, 1982. If an investor partially redeemed a note during that twenty-month period, the remaining funds were re-issued as a new note. The Class' witness on the computer run admitted this at trial: "There was not [sic] assumption, no logic in the program at all to exclude anything at all except by the date of that note

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<sup>31</sup>The preference noteholders had redeemed \$1,762,581.41 worth of notes. JA at 439.

. . . . If the date of the note is 4-22-82. If that's what you call a rollover note, then yes, it would be included." 15 Tr. at 35.

We believe that both of these problems warrant reversing the award of damages in this case. Although the facts and the law certainly justify Arthur Young's liability for state and federal securities fraud, the damage award cannot stand. Arthur Young should not be charged with the \$1.8 million the preference noteholders redeemed before bankruptcy, because at the time of trial the bankruptcy estate had not yet proceeded against them and there was no guarantee that the estate would succeed. Thus, until those

noteholders suffer harm because of the bankruptcy, they have no damages.<sup>32</sup>

Arthur Young should also not be held liable to those whose initial investments in the Co-op occurred before April 22, 1982. In no sense can those noteholders be said to have relied on Arthur Young's nondisclosure (for the Rule 10b-5 claim), nor can it be said that Arthur Young aided the Co-op's commission of securities fraud before it met with the Board (for the state claim). Therefore, we reverse the award of damages and remand for a new trial on this issue. Liability

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<sup>32</sup>We are unable to determine from the record exactly what has happened as regards the preference noteholders. At one point the Class appears to argue that Robertson has not filed actions against them. Robertson and Class Brief at 43. However, in another brief, the Class states that Robertson has filed actions against the preference noteholders. Class' Fees and Costs Brief at 12. This issue should be resolved on remand.

having been established, the Class need only provide evidence of the amount of demand notes purchased for the first time between April 22, 1982<sup>33</sup> and February 23, 1984. This figure will not include the demand notes redeemed within ninety days of bankruptcy unless the district court determines that those noteholders have been injured by the bankruptcy sometime between the original trial and the new trial on damages.

## 2. Measure of Damages

Arthur Young next argues that the district court erred in applying rescissory damages<sup>34</sup> instead of out-of-pocket damages

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<sup>33</sup>If the Class had prevailed only on the Rule 10b-5 claim, the appropriate date would be May 27, 1982, the date of the Co-op's annual meeting.

<sup>34</sup>Rescissory damages "contemplate a return of the injured party to the position he occupied before he was

on the federal securities claim.<sup>35</sup> The district court's remedy functioned to transfer the demand notes from the noteholders to Arthur Young, which could then present the notes to the bankruptcy estate for payment. See Robertson IV, at 61-62. The district court selected this procedure because it greatly simplified a complex issue; benefited Arthur Young, in that the Co-op's bankruptcy estate had been significantly augmented by the various settlements in this case; and placed the Class in the same position it would have been in but for Arthur Young's fraud. See id. at 62-63.

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induced by wrongful conduct to enter into the transaction" and are the monetary equivalent of the property at issue. See Black's Dictionary 354 (5th ed. 1979).

<sup>35</sup>Arthur Young concedes that rescissory damages are proper under the state securities fraud claim.

Arthur Young contends that rescissory damages are only available where the defendant's benefit is greater than the plaintiff's harm. In making this argument, Arthur Young relies on Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), in which the Supreme Court stated that "the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." Id. at 155. Arthur Young ignores, however, a more recent Supreme Court case that also addressed the issue of damages in a Rule 10b-5 case. In Randall v. Loftsgaarden, 478 U.S. 647 (1986), the Supreme Court observed: "The issue whether and under what circumstances rescission or a rescissory measure of damages is available under § 10(b) is an unsettled one." Id. at

661. The Court, after noting Affiliated Ute, continued: "But there is authority for allowing the § 10(b) plaintiff, at least in some circumstances, to choose between 'undoing the bargain . . . or . . . requiring [the defendant] to pay [out-of-pocket] damages.'" Id. (quoting L. Loss, at 1133; latter bracketed material in original opinion). The Supreme Court, however, expressly reserved decision on the point by assuming, arguendo, that a rescissory recovery "may sometimes be proper on a § 10(b) claim." Id. Therefore, contrary to Arthur Young's assertion, Affiliated Ute has not foreclosed the question of whether rescissory damages were appropriate in this case.

This court has previously observed that although Rule 10b-5 damages are normally measured by the plaintiff's out-of-pocket losses, the "out-of-pocket rule

is not a talisman." See Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978). In Garnatz we remarked further, "Indeed, this court has shown no hesitation in varying that measure when necessary on the facts of a given case," and concluded, "Our function is to fashion the remedy best suited to the harm." Id. The Ninth Circuit has even opined that whether rescissory damages are appropriate is within the district court's discretion. See, e.g., Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615, 621 (9th Cir. 1981).

We believe that rescissory damages are best suited to the harm and to the facts of this case. Although we do not believe that simplification alone is a sufficient reason for applying this measure of damages, see Green v. Occidental

Petroleum Corp., 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J. concurring) ("Wrongdoing defendants should not be mulcted to make simple the management of a class proceeding under rule 10b-5."), we do believe that rescissory damages are fair to both parties: the Class receives funds immediately, and Arthur Young has an opportunity to recoup from the Co-op's bankruptcy estate the damages it paid to the Class.

Arthur Young argues that rescissory damages are only proper where the plaintiff is in privity with the defendant. Otherwise, Arthur Young argues, it would be required to perform an impossibility: rescind a transaction to which it was not a party. See Huddleston v. Herman & MacLean, 640 F.2d 534, 555 (5th Cir. Unit A Mar. 1981), aff'd in part and rev'd in part on other grounds, 459 U.S.

375 (1983). Arthur Young relies on a sophism to obscure the law, which is that when the circumstances of a case so dictate, privity is not required for the court to award rescissory damages in a Rule 10b-5 case. As the Eleventh Circuit has concluded: "Though we recognize the harshness of this result given that the defendants were not the actual sellers of the stock and therefore must 'rescind' by paying an amount they in fact never received, the substantial role played by the defendants provides adequate justification for the award." Bruschi v. Brown, 876 F.2d 1526, 1532 (11th Cir. 1989) (quotation omitted). See also Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974) (holding, in a Rule 10b-5 action, that "as between the innocent purchaser and the wrongdoer, who, though not a privy to the fraudulent contract, nonetheless induced

the victim to make the purchase, equity requires the wrongdoer to restore the victim to the status quo.") We conclude that the district court properly determined that a rescissory measure of damages was appropriate based on the facts and circumstances of this case.

### 3. Calculation of Damages

Arthur Young next argues that even if rescissory damages were appropriate, the district court erred in its final determination of the damages because it included interest on the notes. Rescissory damages are measured as follows: "[T]he plaintiff is entitled to a return of the consideration paid, reduced by . . . any 'income received' on the security." Randall, 478 U.S. at 656. Arthur Young argues that to measure the damages as of February 1984 for all of those who invested

earlier than that, and hence earned interest, was error. We agree. Rescissory damages place a plaintiff in the same position she would have been in had she not been induced to enter into the transaction. See Black's Dictionary 354 (5th ed. 1979). Therefore, all the Class is entitled to is the return of its investment in the Co-op, not the investment plus its interest. Any interest the Class is entitled to would come as a result of this action, not the Co-op's program.

Unfortunately, we are not able to determine what actually happened as regards the interest on these notes. The Class' witness on the computer run did not testify on this issue and the record contains some confusing information. See JA at 440 ("The 'Amount Due' calculation represents the total amount of the notes plus simple interest on the notes at the rate indicated

on the computer run minus the interest which was received by individuals on the notes." ). Because it appears that the district court did not address this issue in its post-trial memorandum, see Robertson IV, at 61-66, and the Class has not addressed it in the briefs on appeal, we believe this is best dealt with on remand. Perhaps the awarded damages did not include interest and Arthur Young is wrong. Or it is possible that Arthur Young is raising this argument for the first time on appeal. On the record before us, however, we are unable to make any determination. Therefore, this issue should also be resolved on remand.

#### I. The Settlement Credit

The Class contends that the district court erred in crediting

\$5,744,800<sup>36</sup> in settlement proceeds against the \$6,121,652.94 verdict against Arthur Young. During the course of the proceedings in this case, most of the defendants settled with Robertson and the Class. The settlements totaled approximately \$8.2 million. Robertson and the Class agreed to split the settlement proceeds, allocating \$5.6 million to the Class and \$2.6 million to Robertson. It must be remembered that at this stage, the Class consisted of people who had purchased demand notes after February 15, 1980. The jury then determined that Arthur Young was liable for approximately \$6.1 million in damages to the people who purchased demand notes after April 22, 1982. Because the

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<sup>36</sup>This is more than \$5.6 million allocated to the Class before trial because it includes settlements reached during trial and other corrections made by the district court. See Ja at 1434.

district court fully credited the settlement proceeds against the jury's verdict, the Class argues, Arthur Young gets the benefit of settlements with Class members who had no claim against Arthur Young.

Under federal law, where a "settlement payment and the jury's award pertain [] inseparably to one and the same loss," the verdict must be credited with the payment on settlement. See Kassman v. American Univ., 546 F.2d 1029, 1035 (D.C. Cir. 1976) (per curiam); see also Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 50 (2d Cir.) (holding that Rule 10b-5 damages must be offset by amount of settlement), cert. denied, 439 U.S. 1039 (1978). Under Arkansas law, settlement payments must be credited against a verdict if the settling party is jointly liable with the party against whom the verdict is

rendered. See Ark. Stat. Ann. § 16-61-204 (1987) (formerly Ark. Stat. Ann. § 34-1004 (1947)). For joint liability, both parties must be responsible for the same injury. Id. § 16-61-2001. Even if the parties' tortious acts are temporally separate, if they caused the same injury or loss, the parties are jointly liable. See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank of Little Rock, 774 F.2d 909, 916 (8th Cir. 1985). The district court concluded that Arthur Young and all of the settling defendants were joint tortfeasors, and granted the credit on that ground.

In this case, it is clear that the settlements were not all paid for the same loss. Some of the settling defendants, i.e., Co-op officers and directors, were released from various claims, including claims for common law fraud, negligence,

and RICO violations. See Robertson IV, at 19. Therefore, under either the federal securities verdict or the Arkansas securities fraud verdict, the district court was not required to credit fully the settlement proceeds.

Having reached this conclusion, we still must address the proper allocation of the settlement proceeds. We must place the Class in the same position that it would have been in if not for Arthur Young's fraudulent acts. Therefore, on remand, the district court should first determine what the Class' damages are, as discussed above. The district court should then pro rata allocate the settlement proceeds to all members of the Class and credit Arthur Young with the settlement proceeds allocated to the post-April 22, 1982, demand note purchasers. Arthur Young thus will not receive the benefit of settlements

received by those who had no claims against it, but neither will the Class as a whole be unjustly enriched.

### J. Conclusion

As regards the main appeal in this case, we affirm the district court's judgment in all respects except for the award of damages. We reverse that award and remand for a new trial on the issue of damages alone. At that time the district court shall conduct proceedings consistent with this opinion.

### III.

Consolidated with the main appeal in this case is Arthur Young's appeal on interest, costs, and fees, and the Class counsel's appeal on the issue of his fees.

### A. Interest

Arthur Young challenges the district court's calculation of pre- and postjudgment interest in this case. Because we have remanded for a new trial on the issue of damages, the proper interest will have to be recalculated. To guide the district court, we make the following observations. First, whether to award prejudgment interest is a matter of judicial discretion. See Blau v. Lehman, 368 U.S. 403, 414 (1962). Second, even though Arthur Young is entitled to credit against the verdict as discussed above, Arthur Young is still liable for prejudgment interest on the entire verdict. Again, this is consistent with the rescissory measure of damages used in this case, and contrary to Arthur Young's suggestion, does not operate as a penalty. Third, 28 U.S.C. § 1961 specifically

authorized postjudgment interest, and we believe such interest is appropriate on both the damages and prejudgment interest in this case to compensate the Class for its investment and the interest the investment would have earned if not for Arthur Young's fraud. See Kaiser Aluminum & Chem. Corp. v. Bonjorno, 110 S. Ct. 1570, 1576 (1990).

#### B. Costs

Arthur Young next argues that the district court erred in awarding costs to Robertson and the Class. Arthur Young specifically argues that the district court erred in awarding costs to Robertson's counsel because he did not prevail on any claims and thus was not entitled to costs. See Fed. R. Civ. P. 54(d). Arthur Young overlooks the fact, however, that Robertson's counsel represented the Class

before the Class counsel was appointed. Robertson and the Class also had a joint prosecution agreement, which provided that they would assist one another at trial. See JA at 2435. Having reviewed the transcript, we believe that much of what Robertson's counsel did at trial ultimately benefited the Class. In awarding costs to Robertson's counsel, the district court appears to have taken into consideration Robertson's counsel's lack of success on Robertson's claims, because it only awarded half of the costs requested. However, Robertson's counsel was only entitled to the costs reasonably associated with his representation of the Class. From the record we are unable to determine whether the district court's costs award was reasonably related to the Class representation. Therefore, we reverse the

award and remand for a redetermination of costs for Robertson's counsel.

Arthur Young also challenges the district court's award of costs to the Class. The decision whether to award costs to a prevailing party is committed to the discretion of the district court. See Boyd v. Ozark Air Lines, Inc., 568 F.2d 50, 55 (8th Cir. 1977); Fed. R. Civ. P. 54(d). Arthur Young first contends that the district court's award of \$8755 in costs was error because the Class did not meet its burden of proof with regard to evidence of costs. The Class did meet its burden of proof as regards \$7378 incurred in providing the initial notice to the Class. See JA at 2355-60. Class counsel also attested to approximately \$1500 in copying costs, although there is no supporting documentation. List of Co-op Litigation Expenses of Class Counsel, reprinted in

Arthur Young Brief on Costs, Appendix D. We do not believe that the district court's final award of \$8755, however, constitutes an abuse of discretion on the facts of this case.

Arthur Young also argues that the district court erred in finding that it was not a prevailing party or, alternatively, that the district court abused its discretion in denying the firm's petition for costs. We believe that the district court neither erred nor abused its discretion in denying costs to Arthur Young. Arthur Young next argues that the district court's failure to allocate costs among all forty original defendants constituted an abuse of discretion. We disagree, and note also that Arthur Young has failed to adduce any relevant precedent in support of this claim.

### C. Fees

Arthur Young next challenges the award of attorney fees to Class counsel under Arkansas law. However, it appears from the record that the district court ultimately decided not to award any attorney fees under Arkansas law, because the larger net recovery was under the federal securities claim. In Grogan v. Garner, 806 F.2d 829 (8th Cir. 1986), we stated: "When a federal securities claim overlaps with a pendent state law claim, the plaintiff is entitled to the maximum amount recoverable under any claim." Id. at 839. In this case, the maximum amount recoverable was under the federal securities claim, and the district court thus did not award attorney's fees under Arkansas law. See Letter from District Court to all Counsel at 4 (Oct. 14, 1987),

reprinted in Arthur Young Brief on Costs, Appendix B.

### D. Class Counsel

Finally, Class counsel appeals the district court's reduction of his fee from the common fund established for the Class out of the various settlements. Class counsel requested that \$335,000 of the common fund be allocated to him as a fee. The district court, after much reflection, concluded "given all the circumstances that only someone who 'lived through it' would know, that a reasonable fee for the services performed by [Class counsel] is \$240,000." See Letter from District Court to all Counsel at 1 (Oct. 20, 1987), reprinted in Class Counsel's Brief on Fees, Addendum. After having reviewed the record and the district court's reasoning, although we believe there is some merit to

Class counsel's argument, we find no error in the reduction of his fee.

#### E. Conclusion

In sum, we affirm the district court's ruling on costs and fees except for its determination of Robertson's counsel's costs. On remand, the district court should recalculate the appropriate interest and redetermine the appropriate costs for Robertson's counsel.

#### IV.

Accordingly, the judgment of the district court is affirmed in part and reversed in part. In sum, we conclude that the district court: properly certified the Class; properly dismissed Robertson's breach of contract claim; properly granted summary judgment in favor of Arthur Young on the RICO claim; properly ruled that the

demand notes were securities under Arkansas law; properly denied Arthur Young's motion for JNOV on the state and federal securities fraud claims; properly denied Arthur Young's motion for a new trial on the contribution issue; erred in part on the damages awarded; erred in granting Arthur Young full credit for settlement proceeds; and properly determined all costs and fees except for the fees for Robertson's counsel. This matter is remanded to the district court for further proceedings as discussed above.

A true copy.

Attest:

CLERK, U. S. COURT OF  
APPEALS, EIGHTH CIRCUIT.

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SUPREME COURT OF THE UNITED STATES  
OFFICE OF THE CLERK  
WASHINGTON, D.C. 20543

February 24, 1992

Mr. Gary M. Elden  
Grippio & Elden  
227 West Monroe Street  
Chicago, IL 60606

Re: Bob Reves, et al.  
v. Ernst & Young  
No. 91-886

Dear Mr. Elden:

The Court today entered the following  
order in the above entitled case:

The petition for a writ of  
certiorari is granted.

Very truly yours,

/s/ William K. Suter  
William K. Suter, Clerk

---

APR 17 1992

OFFICE OF THE CLERK

No. 91-886

In The  
**Supreme Court of the United States**  
October Term, 1991

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BOB REVES, ROBERT H. GIBBS, and  
FRANCES GRAHAM, As Representatives Of  
A Class Of Note Holders,

*Petitioners,*

v.

ERNST & YOUNG,

*Respondent.*

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On Writ Of Certiorari To The  
United States Court Of  
Appeals For The Eighth Circuit

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**BRIEF FOR PETITIONERS**

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**QUESTION PRESENTED**

Does section 1962(c) of the RICO statute – which makes it “unlawful for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of [the] enterprise’s affairs through a pattern of racketeering activity” – require proof that the defendant control the management or operation of the enterprise?

## PARTIES TO THE PROCEEDING BELOW

In addition to the parties listed in the caption, parties to the proceeding below included Thomas E. Robertson, Jr., as trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc., and Robert C. Cloar, class counsel.

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## OPINIONS BELOW

The opinion of the U.S. Court of Appeals for the Eighth Circuit is reported at 937 F.2d 1310, and is reproduced in the Joint Appendix ("JA") at JA 226-352. The summary judgment opinion of the U.S. District Court for the Western District of Arkansas is unreported and is included in the Joint Appendix at JA 1-222.

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 JURISDICTIONAL GROUNDS

On June 27, 1991, the Eighth Circuit affirmed in part and reversed in part the judgment of the district court. On August 29, 1991, the Eighth Circuit denied Ernst & Young's petition for rehearing. On November 27, 1992, the Class timely filed a petition for a writ of certiorari. By order dated February 24, 1992, this Court granted the Class' petition. (JA 353.)

This Court has jurisdiction to review the judgment below by writ of certiorari pursuant to 28 U.S.C. § 1254(1). The courts below had federal jurisdiction pursuant to 28 U.S.C. § 1331.

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 STATUTE INVOLVED

The statute involved in this petition is 18 U.S.C. § 1962(c) of the Racketeer Influenced and Corrupt Organizations Act, which provides:

It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

## STATEMENT OF THE CASE INTRODUCTION

The Eighth Circuit provides an accurate overview of the facts in (JA 231-69),<sup>1</sup> and we adopt its definitions.<sup>2</sup> However, as the Eighth Circuit was dealing with three sets of appeals and over twenty issues, it could not, as we will below, detail the evidence critical to three pending factual issues: what were the Co-Op's "affairs"; how Arthur Young "participated" in the "conduct of" those "affairs"; and whether anyone other than Arthur Young initiated, encouraged, or assisted the securities frauds at issue.

<sup>1</sup> Citations in this brief observe the following formats. Citations to the Joint Appendix are in the form "JA \_\_\_\_." Citations to the Court of Appeals Joint Appendix are in the form of "CAJA \_\_\_\_." Citations to the trial transcript are by volume and page in the form "Trans. \_\_\_\_:\_\_\_\_."

<sup>2</sup> After all trial evidence was admitted, plaintiffs moved for and the judge granted reconsideration of the pre-trial summary judgment on RICO issues. The trial court then reaffirmed its earlier ruling based on the combined trial and pre-trial record. (Trans. XV:48-51.)

## THE CO-OP'S AFFAIRS

The Co-Op was a nonprofit association open to all farmers in eastern Oklahoma and western Arkansas. The Co-Op bought farmers' grain and sold them agricultural necessities ranging from seed to tractors. Farmers could become Co-Op "members" (for a small fee) and then be credited with an allocable share of its annual "savings" (profits).

One service the Co-Op provided its rural members was a handy place to make an interest-bearing investment while selling grain or buying fertilizer. On its premises, the Co-Op sold notes, payable on demand, earning interest slightly in excess of bank rates. The Co-Op's financing came primarily from these notes, which in 1981-84 totalled about \$12 million and provided 65-75% of the Co-Op's total financing. (See CAJA 231-33, 239, 262, 326.)

## THE CO-OP'S MANAGEMENT

The Co-Op's Board of Directors consisted of nine persons, all farmers, few with more than a high school education, who served for nominal pay as a community service. (Trans. III:188-90; XI:252-53, 271; XII:140, 232.) After the Co-Op's general manager (Jack White) and its internal accountant (Gene Kuykendall) were convicted of self-dealing, theft of Co-Op funds, and falsification of Co-Op records in January 1981,<sup>3</sup> a "reform" movement arose

<sup>3</sup> The indictment, technically for tax fraud, charged White with a "course of self-dealing" between 1973 and 1979, "using

(Continued on following page)

in the membership to replace the old directors as they came up for re-election. (Trans. XII:23-24.) As a result, the members replaced four incumbents in contested elections at the spring 1981 meeting. (Trans. XI:251-52; XII:188.)<sup>4</sup> At the board level, the newest directors by a 5-4 vote replaced the incumbent president (an "old" director) with a "new" director in 1982. (Trans. XI:285-86.)

*The General Manager* was in effect the Co-Op's chief executive officer. (See JA 231, 253-54.) In April 1982, general manager White's conviction was affirmed and he went to prison. (Trans. XII:25.) After that, in another split vote, the Board demanded (and got) White's resignation.

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(Continued from previous page)

moneys from the [Co-Op] in excess of One Million Dollars, on more than one occasion, which enriched JACK E. WHITE; and using [Co-Op] moneys . . . which enriched corporations in which JACK E. WHITE had a financial interest [or] . . . benefited [his] associates . . ." and charged both White and Co-Op auditor Kuykendall with having in many specific ways "agreed to conceal and disguise the true nature of the [self-dealing] transactions on the [Co-Op] books [and] records. . . ." (CAJA 893-94.) Affirming the conviction, *United States v. White*, 671 F.2d 1126, 1134 (8th Cir. 1982) (CAJA 906, 914) stated the essence of the case as: "The record clearly demonstrates that White and Kuykendall manipulated the Co-Op's finances to serve their own personal ends, and that they distorted the Co-Op's records . . . ."

<sup>4</sup> Since another director had been newly elected in 1980, starting in spring 1981 five of the nine directors had not been in office during the 1973-79 activities for which White had been convicted. This majority increased to 6-3 and 8-1 as more incumbents were thrown out at the 1982 and 1983 elections. (CAJA 231-32, 362-65.)

(See Trans. XII:25-27.) The Board replaced White with an outsider, Fred Howard, in August 1982. Because Howard knew nothing about the Co-Op's financial condition, he wanted a special mid-year audit before he took office. To save the cost of such an audit, the Board agreed that Howard was indemnified and not responsible for actions and records until 1983. (Trans. XI:281-82.) The resolution effecting this indemnity was given to Arthur Young. (Trans. XI:282-83.)

In the period *between* White's jailing and Howard's hiring, i.e., when the Co-Op had no functioning general manager, Arthur Young first met the new board and presented Arthur Young's proposed 1982 report (for year-end 1981). (The sequence of events each year is: outside auditors present report; directors approve report; annual meeting held to present report and elect some new directors. (Trans. XI:255.)) Thus, a new director could wait a year to first meet the auditors. In this case Arthur Young first met with the directors elected in March 1981 on April 22, 1982, when Arthur Young had drafted its proposed report. (Trans. XI:254-55.) Also *between* White's jailing and Howard's hiring, Arthur Young had numerous meetings with the Board, concluded its audit, and finalized its 1982 report.

*The Co-Op's only inside accountant*, Kirit Goradia, used the title "office manager." His role (and disclaimer of responsibility) is summarized by the Eighth Circuit. (JA 253-55 & n.10 (Goradia refused to verify accuracy of, or take any responsibility for, Co-Op records).)

*The Members and Investors* were told about the Co-Op's assets, liabilities, and profits or losses once each

year at an annual meeting. This was traditionally done by the outside accountant for the Co-Op, a tradition continued by Arthur Young. A condensed financial statement was generally passed out at or before the meeting, another tradition continued under Arthur Young. The meetings were in the evening, once a year, and covered many issues other than finances.

### THE ROLE OF ARTHUR YOUNG: 1981-1983

*1981 Criminal Trial.* When White and Kuykendall were indicted in September 1980 (*see supra* note 3), they hired the law firm of Ball & Mourton both to defend them and to represent the Co-Op's interests. (The Co-Op eventually paid all bills.) Ball & Mourton, which specialized in tax fraud cases, hired as defense experts Russell Brown & Co. (which later that year merged into Arthur Young). The head of the firm, Harry Erwin, and the head of its tax department, David Ray, testified for the criminal defendants. (Trans. IX:155.) Ray was present for the entire trial and had to understand the whole case against White and Kuykendall since he had responsibility for summing up the testimony. (Trans. V:168-69.)

*White Hires Arthur Young.* Between White's 1981 conviction and the 1982 affirmance (and his jailing), White, with Ball & Mourton, interviewed trial witness Erwin and other Arthur Young representatives to be the Co-Op's new auditors. (JA 238.) The Co-Op hired Arthur Young in November 1981. (JA 238; CAJA 1093.)

*The Gasohol Plant.* Arthur Young soon confronted what they promptly recognized as another example of self-dealing and falsified records implicating not only

their recent clients White and Kuykendall but also Ball & Mourton, the firm that had referred White and the Co-Op to Arthur Young.

To understand what happened, it is necessary to go back to early 1979, when White and an outsider, Ed Dooley, had invested \$125,000 each in a gasohol plant. (JA 233; CAJA 1124-32.) On October 30, 1979, White bought Dooley out for \$125,000, (JA 233; CAJA 938-40), and borrowed \$250,000 from Citizens Bank, of which White was Chairman and a major stockholder. The gasohol corporation later borrowed another \$300,000 from Citizens. (CAJA 934-37.) In 1980, White began borrowing from the Co-Op, owing it \$4.1 million by December. (JA 234; CAJA 967-73.) Thus, by December 1980, White owed his bank \$550,000 and the Co-Op \$4,100,000.

The gasohol plant went into production in April 1980 and by December 1980 had the following problems: grain prices rose, oil prices dropped, equipment did not work, the plant only operated at 20% capacity (JA 240), pollution authorities shut down the plant and required purchase of new expensive abatement devices, and the Republican presidential candidate (who won in November 1980) opposed the previous Democratic administration's tax breaks and subsidies without which gasohol was not a viable product. (*See* Trans. II:33-34.) At year-end 1980 the plant was worth between \$500,000 and \$750,000, according to one appraiser; between \$450,000 and \$1,500,000, according to another. (JA 245 n.7.)

After White was indicted and before he went to trial, White told Ball & Mourton of his gasohol problems and

Ball & Mourton proposed a "friendly lawsuit" by the Co-Op against White to: cause the Co-Op to pay the \$550,000 to White's bank; cancel White's \$4.1 million debt to the Co-Op; and transfer the gasohol plant to the Co-Op. (CAJA 923-27.) Between December 12 and 19, 1980 the Co-Op filed "its" complaint; White answered (with a denial); and the parties "settled" by agreed decree. The decree was not filed until five weeks later, after White's trial ended. (CAJA 928-31.) The decree was approved by a judge who heard no evidence because the case was described as "settled." (Trans. IX:79-84.) The friendly lawsuit pleadings and many key corporate records of the gasohol plant were given to Arthur Young and maintained in its workpapers. (See *infra* note 6.)

*Arthur Young Decides How To Book The Gasohol Plant.* If the Co-Op bought the gasohol plant from White, as the friendly lawsuit complaint and decree provided, then the accounting rules inflexibly required the Co-Op to record the plant at fair market value as of the acquisition date. (JA 242-44.) Since that value was less than \$1.5 million (and probably less than half that), had it been so booked the Co-Op instantly would have become insolvent (*i.e.*, had a negative net worth). That would have caused a "run" by holders of demand notes, which would have caused all financing to be withdrawn and the Co-Op to have declared bankruptcy. (JA 245.)

Those developments, on the heels of the recent convictions, could have led to investigations, indictments, disbarments, license revocations, and multi-million dollar civil liabilities not only for Arthur Young's clients White and Kuykendall, but for Arthur Young's referring counsel

Ball & Mourton. With the "new" reform directors in a potential majority, White in jail, and a new general manager yet to be hired, Arthur Young had fundamental decisions to make about who to consult and what to advise them.

Arthur Young decided to consult no one, and instead, unilaterally decided to book the plant at \$4.5 million, between 300% and 900% more than its true value, based on three critical business conclusions (discussed in the next three sections). Arthur Young never discussed these conclusions with the directors (or, when he was hired later, the new general manager Fred Howard). (Trans. XI:267-73; XII:145-48, 192-93, 236-40.)<sup>5</sup> As a result of booking the gasohol plant at \$4.5 million (rather than the true value – under \$1.5 million), the Co-Op showed an apparent positive net worth of \$2.6 million (at year-end 1981) and \$1.4 million (at year-end 1982). (JA 245-47, 256; see also Trans. IX:175 (Arthur Young prepared the financial statements).)

*Arthur Young Claims It Did Not Book The Plant At Value Because The Co-Op Did Not Buy It.* At trial, to justify this accounting treatment, Arthur Young had to claim that the Co-Op did *not* acquire the gasohol plant but always

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<sup>5</sup> Indeed, at its first meeting with the Board on April 22, 1982, Arthur Young did not even reveal the friendly lawsuit. The "new" directors learned about the suit only when one, pursuing a rumor, went to court himself, searched the court files, found the pleadings, and showed them to the other "new" directors at a board meeting. (Trans. XI:261-68.) That was the first any of them knew of the friendly lawsuit. (Trans. XII:192-93, 236-37.)

owned it. Arthur Young claimed it believed that the "economic substance" of the transaction made this true. (See Trans. IX:214-15.) Plaintiffs claimed Arthur Young could not have believed that, invented it to avoid the correct accounting treatment, and lied about its reasons for doing so. The jury, having been instructed that Arthur Young could be found guilty only if Arthur Young "originated" the fraud, had "no honest belief in the truth of the [Co-Op's financial] statements," "acted with actually fraudulent intent," and was proven wholly lacking in "good faith" (Trans. XVIII:71-81), agreed with plaintiffs.

Judge Waters explained Arthur Young's critical role in reaching this key conclusion (JA 136-38 (emphasis in original)):

[A] jury might reasonably find that Arthur Young's audit report was dictated by the *result* it wished to achieve . . . .

The records may permit a reasonable jury to find that the auditors adopted a blatant fiction - that the Co-op owned the entire plant at its inception in May, 1979 - in order to justify carrying the asset on its books at its total cost, as if the Co-op had built it from scratch. The auditors indulged this fiction despite being aware of the Chancery Court decree which said it assumed ownership of the plant in February, 1980, at a time when it was substantially completed. . . . A reasonable jury could conclude that the Arthur Young defendants picked an acquisition date out of the air that they could "justify," in order to record assets onto the books in a way that would make White's management "look better."

If that is what Arthur Young did, they did so without consulting Fred Howard (who was not there yet) or the

Board, (Trans. XII:145-47, 192, 236-37), and in contravention of all available Co-Op records, including even what Ball & Mourtou and White had put in the friendly lawsuit pleadings.<sup>6</sup>

*Arthur Young Inflates The "Cost" Of Construction.* If the Co-Op did not buy the plant but built it, the Co-Op

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<sup>6</sup> Arthur Young's workpapers (CAJA 1099-1173) concluded: "The Co-Op acquired White Flame by the assumption of a \$250,000 debt of White Flame's sole stockholder [White] . . . via a court order which set the acquisition date in February, 1980." (CAJA 1234, 1239, § V(13b).) The workpapers contained the "friendly lawsuit" decree which purported to transfer title to the Co-Op and, tracking the complaint (CAJA 923-27), recited that Dooley and White were the original owners, that White had bought out Dooley, and that White from October 1979 to February 1980 was sole shareholder. Arthur Young's workpapers also contained documentation that: the gasohol plant company was incorporated in 1976 by Ed Dooley, a man unrelated to the Co-Op; he named it "Big D [for Dooley] Enterprises"; on May 1, 1979, he and his wife, its sole officers, and Jack White met to change the name to "Big D&W [for Dooley and White] Refining and Solvents Co., Inc."; shares were then issued to White and Dooley; August minutes showed them to be its sole shareholders, directors, and officers; the corporate tax form showed each owned half; each contributed \$50,000 in June and \$75,000 in July, the company's entire capitalization; White bought Dooley's interest on October 30, 1979 for \$125,000, after which the corporate name was changed to White Flame; the tax return stated White was sole shareholder at December 31, 1979; the Co-Op's 1979 tax return and audited financials showed no interest in the gasohol plant; and the Co-Op's 1980 audited financials stated that White Flame was "acquired in February 1980." (CAJA 1099, 1106-24, 1133-35, 1142, 1150-56, 1162-71, 1185, n.5; Trans. II:17.)

needed to calculate its "cost" of construction in order to determine the proper book value. Kuykendall's audit at December 31, 1980 had used a cost figure of \$4,393,242.66. Normally, an accountant would start with that number and add to it any post-1980 costs to get the 1981 number. But Arthur Young determined they could not use Kuykendall's figure, laughed about its unreliability, and put quotation marks around the word "audit" in referring to what Kuykendall had done. (CAJA 1190; Trans. IX:178-85; XI:96.) Further, to use Kuykendall's number, Arthur Young had to talk to him about how he had reached it, which they never tried to do. (Trans. VII:259; XIV:210.) Nevertheless, Arthur Young used for its December 31, 1980 "cost" figure the exact same \$4,393,242.66 (which rose to \$4.5 million with the addition of certain construction costs and capitalized expenses). (JA 241-42.)

To explain this, Arthur Young auditor Drozal testified that he had conducted his own "independent" review of the gasohol plant books and, by a remarkable coincidence, happened to arrive at the same exact number, \$4,393,242.66. (JA 138-40; Trans. IX:185-86.) He adopted that story before he knew that Kuykendall would admit that he had "essentially invented" the asset number, which he had deliberately inflated to avoid showing a "tremendous big loss." (JA 139-40.) Specifically, Kuykendall later admitted he and White originally kept a second set of books which fraudulently inflated asset values by "capitalizing" ordinary operating expenses instead of deducting them from profits. After their indictment, Kuykendall and White feared this looked too blatant, so they created a *third* set of books capitalizing only 70-90% of each expense, using totally arbitrary amounts, and

keeping about 80% of the original fraudulent inflation of assets. (See Trans. VII:244-59.) Kuykendall then "audited" his own numbers in one day, claiming he had used "a hybrid accrual method," a term that he made up. (Trans. VII:261-63; CAJA 1201.) Arthur Young knew this method was fictional and found the whole "audit" humorous. (Trans. IX:178.)

To again quote Judge Waters (JA 140-41 (emphasis added)):

A reasonable jury would be justified in concluding that Arthur Young did not independently arrive at Kuykendall's figure, and that the odds against their having done so were astronomical. A reasonable jury could find that *Arthur Young had no actual belief in its audit report: either in the cost figure at which to record the gasohol plant or in the fiction which they employed to justify carrying the asset at cost. A reasonable jury could conclude that the determination to carry the asset at cost rather than value was critical to the presentation of the Co-op as "a going concern."*

If Arthur Young witnesses lied at trial about how they came up with their inflated cost figure, the reasonable inference is that Arthur Young lied about and concealed their methods at earlier times from everyone else at the Co-Op.

*Arthur Young Avoids Writedown.* Another obstacle remained. Even if Arthur Young was justified in using the inflated \$4.3 million figure as the plant's cost of construction through December 31, 1980, and even if it might be

able to avoid the iron rule that it use value, not cost, for acquired property, accounting rules still required the plant to be "written down" to the *lower* of cost or value if the cost was not likely to be recovered through future operating profits. (See Trans. XIV:191-95, 201-09.) Arthur Young understood this; its workpapers, which identified and analyzed this issue, concluded that "the plant could not produce enough volume to provide sufficient income to ever cover expenses of manufacturing and operations." (CAJA 1238, § V(4).)<sup>7</sup>

However, Arthur Young decided not to recommend a writedown to value. When Arthur Young discussed the issue with the directors, Arthur Young said that "in the future" the Co-Op "might" have to write down the plant's book value, but that no write down had to be considered in 1981-83. (Trans. XI:277-78; XII:147-48, 240.)

*Related Party Transactions.* Arthur Young conceded that it had to give extra scrutiny and care to any "related party transaction," which included any dealing between White and the Co-Op. While White was general manager this duty was intensified by White's conviction. Yet Arthur Young did not consider the gasohol plant purchase a related party transaction. (Trans. IX:169-70, 201-05; CAJA 1239.)<sup>8</sup> Arthur Young audited many

<sup>7</sup> The workpapers showed costs of production exceeding selling price by at least \$1/gal. and by 20-35 cents/gal. even ignoring interest and overhead. (CAJA 1220.) In other words, if someone gave you the plant and did all your administrative work free, you still would be better off giving it back than trying to run it.

<sup>8</sup> Arthur Young deemed the Co-Op a "close monitoring client." (CAJA 1234, 1237-40, § V.) That is Arthur Young's term for a client that can cause Arthur Young embarrassment and financial exposure. (Trans. IX:205-06, XI:116.)

related-party transactions other than the gasohol plant. We discuss one below because it bears on the degree of Arthur Young's involvement in the Co-Op.

At White's criminal trial, White tried to justify getting money from the Co-Op by testifying that he bought (a) \$1.5 million in bonds payable by the Co-Op at 8% interest with (b) proceeds of a \$1.5 million *no-interest* loan from the Co-Op (CAJA 895); thus the Co-Op owed him \$120,000 annually. In investigating this related-party transaction after the conviction, Arthur Young discovered that on the \$1.5 million loan, White had actually signed a promissory note agreeing to pay the Co-Op interest of 10% (\$150,000) per year. (CAJA 1095, 1227; Trans. IX:170-73; XI:258-60.) Obviously this discovery raised all sorts of legal and ethical questions about perjury, subornation, and fraud by Arthur Young's recent clients White and Kuykendall and the source of Arthur Young's business, Ball & Mourton. It also created a large unbooked debt that White owed the Co-Op. However, rather than tell the Board about this discovery or mention it in the Co-Op financial statements, Arthur Young stuck the promissory note back in the file and acted as if it did not exist. (CAJA 1094; Trans. IX:172-73.)

To Arthur Young's dismay, however, one "new" director diligently uncovered the note and brought it to Arthur Young's attention, seeking guidance. Arthur Young told the director it was "too late to do anything," and persuaded him that raising it at a Board meeting would only "open a can of worms." (Trans. XI:258-60.) Since the director followed Arthur Young's advice, no

other "new" director ever learned of the note. (Trans. XII:145-49, 194.)

*What Arthur Young Told The Investors In 1982.* Investors (and other Co-Op members) learned of the Co-Op's financial condition at its annual meeting, when they received "condensed" financial statements. (JA 248-49; see also CAJA 230-31 (condensed statements also distributed to members with Notice of Annual Meeting).) The 1982 condensed statement listed \$7.5 million in "Land, Buildings, Equipment and Vehicles," but did not disclose that this included the gasohol plant valued at over \$4 million. (Trans. XII:112-13.) Moreover, the statement inconsistently did *not* include the gasohol plant's \$1.3 million 1982 loss, thereby allowing the Co-Op to show a \$154,012 profit (net savings) rather than a loss of over \$1 million. (See CAJA 240.) The Co-Op mailed a draft condensed statement to Arthur Young and received it back, without any changes, before the annual meeting. (See Trans. XII:104-06.) Arthur Young knew at that time that the condensed financial statements were misleading, as Arthur Young noted in its audit workpapers and admitted at trial (CAJA 1240, § V(15); Trans. X:121; XI:125, 146-47).

The 1982 condensed statement came with a meeting agenda that listed "Financial Report . . . of Harry Erwin, C.P.A., Arthur Young & Company." (CAJA 231.) Erwin limited his oral report to "some of the highlights of the condensed statements." In response to "heated and fast and furious" questions from the floor, Erwin corrected no

errors and evaded all questions. (Trans. XII:107-13.) To Judge Waters, "it rather appeared as if the meeting were designed to forestall inquiry that would uncover the truth, rather than for any other reason." (CAJA 64.) According to Erwin's partner Cabaniss, Erwin "responded to the questions, but he did not answer the questions." (Trans. XI:102.)

*What Arthur Young Told The Investors In 1983.* Again in 1983, the Co-Op consulted Arthur Young regarding the condensed statements; again Arthur Young reviewed drafts before the meeting; again Arthur Young concluded they were misleading; again Arthur Young did not tell the directors the statements were misleading; again the misleading statements were used; and again when Arthur Young (this time Cabaniss) made the presentation to the annual meeting, he spoke only two or three minutes and did not suggest in any way that the condensed financial statements were misleading or reveal that the Co-Op was insolvent. (Trans. XI:147-52, 280.)

*What Arthur Young Told The Government.* Later in 1983, the United States Department of Agriculture ("USDA"), which could suspend the Co-Op's grain license if it were insolvent, asked Arthur Young about the Co-Op's financial condition. Arthur Young's answering letter, full of jargon and double-talk (CAJA 1261-62), in effect claimed that it was "impossible" to obtain an appraisal or other analysis showing the value of the gasohol plant. (See Trans. X:144-48.) Arthur Young, however, had already done such an analysis. (CAJA 1220.) Also, the directors already had authorized an appraisal, and indeed, repeatedly asked Arthur Young to help the Co-Op find an appraiser. (Trans. XI:276-77; XII:195, 239.) (At trial, all

parties hired appraisers as trial witnesses. (CAJA 1355-56, 1375; Trans. X:147.))

*What Arthur Young Told The Board.* On April 22, 1982, Arthur Young met the directors, handed them a report, and tried to hurry them to approve it. The directors, realizing how complicated it all was, demurred and asked for additional meetings with Arthur Young. Although they were paid only \$50 a month, the directors attended numerous "special meetings" – five in July alone. (Trans. XI:269-72.) At these and at similar meetings in 1983, as noted above, Arthur Young failed to tell the directors of Arthur Young's three key factual conclusions underlying the carrying value of the gasohol plant. The closest Arthur Young ever came to any matter now at issue was when Arthur Young talked of a "possible" need for a "future" writedown of the value of the gasohol plant, but this was always described as a "future" problem, not one that had to be addressed in 1982 and 1983. (Trans. XII:147-48, 240.) Arthur Young never discussed with the directors the subject of management representation letters (Trans. XI:284), and never disclosed that Kirit Goradia had refused to sign one. (Trans. XI:284-85.)

The Co-Op ultimately declared bankruptcy in February 1984. (JA 260.) Davis, a "new" director who was elected in 1982 and remained in office until the bankruptcy, had such an understanding of the Co-Op's financial condition that Davis owned \$11,000 in Co-Op demand notes at the time of bankruptcy. (Trans. XII:231-36, 241.)

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## SUMMARY OF THE ARGUMENT

I. We begin by comparing the facts of this case to the plain meaning of the key statutory words. "Affairs" is an all-inclusive term which can include such important activities as raising the funds used by the enterprise to operate and providing an investment service to members (here, the Co-Op demand note program itself). The "conduct" (or "carrying on") of the demand note program can include origination of the Co-Op's fundamental financial data, use of that data to create the Co-Op's financial statements, and reporting on the Co-Op's financial condition to members and investors. "Participate" and "indirectly" have settled meanings of broad compass used for decades to extend liability to persons who assist, aid, share, or associate with primary wrongdoers. Those words together plainly cover an auditor which invents and implements a securities fraud with little help from the issuer's general manager, internal accountant, or directors. The Eighth Circuit and especially the district court opinions are consistent with the above analysis; they, however, conclude that the *dictum* in *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008 (1983), essentially precludes a RICO action against an auditor.

II. *Bennett* evolved from a brief *dictum* "observation" to a "restrictive" rule apparently requiring proof of "significant control" over "management or operations." As such, *Bennett* is incompatible with several statutory terms ("employed" and "associated," as well as "participate," "indirectly," and "affairs"). By its stringency, *Bennett* prevents RICO from covering exactly what Congress

intended to cover, including most cases of bribery, and raises a host of other insolvable interpretive questions. *Bennett* is not consistent with the holdings in six of the seven other circuits which have addressed the issue. To avoid these problems, the statutory term "conduct" must be construed more broadly than *Bennett* (and *Yellow Bus*) suggest; in any event, whatever meaning is given "conduct," it inherently cannot limit RICO in any relevant manner here given the breadth of "participation" and "affairs."

III. Although petitioners have no reason to criticize other appellate tests, and would prevail under any of them, these other tests have problems which parallel those in *Bennett*. Though not needing to succeed on this point to prevail, petitioners advance an alternative, statutory-language approach.

### ARGUMENT

#### I. A JURY COULD FIND THAT ARTHUR YOUNG "PARTICIPATED" IN THE "CONDUCT" OF THE CO-OP'S "AFFAIRS."

The Racketeering Influenced and Corrupt Organizations Act ("RICO"),<sup>9</sup> creates a civil remedy, 18 U.S.C. § 1964, for violations of the substantive provisions in 18 U.S.C. § 1962. Section 1962(c) provides in part:

<sup>9</sup> Title IX of the Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 941.

It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity . . . .

18 U.S.C. § 1962(c) (emphasis added).

Two matters are not in dispute. First, RICO defines "racketeering activity" to include federal securities frauds. 18 U.S.C. § 1961(1)(D); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 481-82 & n.3 (1985). Here the jury found Arthur Young to have "originated" securities frauds and the jury's verdict has now become a final affirmed judgment. Second, the Co-Op is plainly an "enterprise" involved in interstate (including Oklahoma-Arkansas) commerce.

Thus, for the present inquiry, the relevant phrase of the statute can be parsed to yield a question with four parts. Could a jury conclude that Arthur Young (1) did "participate, directly or indirectly," (2) "in the conduct of" (3) the Co-Op's "affairs" (4) "through" the securities frauds Arthur Young originated? Ordering these in the most logical sequence produces:

(A) Did the Co-Op's "affairs" include the demand note program used both to finance the enterprise and to provide a service to members and others wishing to invest their money?

(B) If so, did the "conduct" of the Co-Op's demand note program include origination of financial data, creation of financial statements,

and financial reporting to members and investors?

(C) If so, did Arthur Young "participate, directly or indirectly, in" the conduct of those affairs?

(D) If so, was Arthur Young's participation "through" the securities frauds that were the subject of the jury verdict?

Posed this way, the questions are not difficult to answer:

(A) A jury could find, for two independently compelling reasons, that the Co-Op's demand note program was a major component of its "affairs." First, the sale of demand notes supplied 65%-75% of the Co-Op's total financing. New note sales were constantly needed to replace retired ones. An enterprise's major source of financing, necessary to its survival and requiring continuous activity, can surely be considered part of its business "affairs," which, according to *Black's Law Dictionary* (1951), is "[a]n inclusive term, bringing within its scope and meaning anything that a person may do." Among the specific definitions *Black's* provides is: "A corporation's borrowing money, and methods of obtaining loans." *Id.*<sup>11</sup>

<sup>11</sup> In construing RICO, words with settled meanings should be given controlling effect. "If the statutory language is unambiguous, in the absence of 'a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive.'" *United States v. Russello*, 464 U.S. 16, 21 (1983) (quoting *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)). If there is to be any departure at all from customary meaning, however, "RICO is to be read broadly" in keeping with the statute's explicit

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Without an active demand note program, the Co-Op would not have been able to operate (as ultimately occurred).

Second, the notes were an important service provided to the Co-Op's members. Rural people not regularly travelling near offices of banks or brokers, the members could conveniently invest in demand notes the funds they received when they sold their grain. They also could cash in the demand notes to raise funds when they bought a harvester. Since the nonprofit Co-Op existed only to serve its members, a jury could find such a service to be as much a part of the Co-Op's "affairs" as buying grain or selling fertilizer.

(B) A jury could find that "the act, manner or process of carrying on" (i.e., "the conduct") of the Co-Op's demand note program included the *creation* and *presentation* of the Co-Op's financial information.<sup>12</sup> Significantly, when we speak here of creating fundamental financial data and using it to prepare books, records, and financial

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direction, 18 U.S.C. § 1961 note, to construe the statute liberally in order to effectuate the remedial purposes of the statute and in view of "Congress' self-consciously expansive language and overall approach." *Sedima*, 473 U.S. at 497-83. "Affairs" illustrates Congress' "pattern [of] utilizing terms and concepts of breadth," *Russello*, 464 U.S. at 21.

<sup>12</sup> According to *Webster's Ninth New Collegiate Dictionary* (1983), the noun "conduct" includes "the act, manner or process of carrying on." We comment at greater length in Part II on the improperly restrictive overlays given to "conduct" in the *Yellow Bus/Bennett* test.

statements, we are speaking of what a *company* customarily and necessarily must do in order to have something that can be *subjected* to an audit: *e.g.*, determining whether an asset was bought or whether it was built, and forming (or obtaining) opinions as to valuation and likely recovery of costs. We thus distinguish between what Arthur Young did here and what an auditor does in the course of its job.

A jury also could find that the "conduct" of the Co-Op's affairs include financial reporting to the Co-Op's members and investors. Each year, members were entitled to share in profits (called "net savings"). Members had the sole power to elect directors and thus were entitled to some accounting of finances. Members had to decide whether to invest in the demand note program, and Arthur Young knew such continued investment was vital to the Co-Op's survival.

In sum, the creation of financial information, the preparation of financial statements incorporating such information, and the communication of financial reports to members and investors were essential to the "conduct" of the Co-Op's demand note program. Without the creation of favorable financial information and the reporting of that information to members and investors, the demand note program of the Co-Op, and the Co-Op itself, would have foundered. No one would have invested their money by buying demand notes from the Co-Op had he or she known that the Co-Op was insolvent.

(C) In determining whether Arthur Young did "participate, directly or indirectly, in" the conduct of the affairs described above, the first step is to consider the

word "participate" (and its modifier "indirectly"). Before RICO was adopted, "participate" had an established broad meaning, both generally in the common law, and specifically in federal court explanations of aiding and abetting liability and the law of federal securities frauds (both of which can be viewed as forerunners to and current sources of RICO liability).

In the common law, participate is considered "a word in common usage" which "denotes either active or passive sharetaking." 67A C.J.S. 627 (1978). Although it has various shades of meaning, one "commonly accepted meaning . . . indicates sharing"; another is "to have a part in and to share"; another "connotes to the average person the meaning and effect of 'engage in.'" Also, "[o]ne who takes part in a single action participates therein for the word 'participate' applies equally to a single act or to many acts." *Id.*; accord *Black's Law Dictionary, supra*.

Moving closer to RICO, federal courts have long used "participate" to explain aiding and abetting, often quoting Judge Learned Hand. To aid and abet, Judge Hand wrote, a defendant must "in some sort associate himself with the venture, that he participate in it as something that he wishes to bring about, and that he seek by his action to make it succeed." *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938), *adopted in Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949). Judge Hand's words continued to be applied after RICO's enactment. *IIT, An Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 922 & n.15 (2d Cir. 1980); *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 163 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

Because "participate" is a key word used to explain aiding and abetting, federal courts on occasion elaborate on what it means to "participate." The Fifth Circuit explained that "[t]o prove participation, there must be evidence to establish that the defendant *engaged in some affirmative conduct*; that is, there must be evidence that the defendant committed *an overt act designed to aid in the success of the venture.*" *United States v. Longoria*, 569 F.2d 422, 425 (5th Cir. 1978) (emphasis added).

Securities law violations, predicate acts under RICO, use the term "participant" to describe a person potentially liable for illegal sales. E.g., *Brick v. Dominion Mortgage & Realty Trust*, 442 F. Supp. 283, 306 (W.D.N.Y. 1977). The statutory term "active participants" was held to include not only "[p]ersons participating directly" in a statutory violation but also "those persons who are aware of, and to some lesser degree, participate in a violation of the securities laws and either enter into an agreement with or give assistance to the primary wrongdoers." *Id.* (emphasis added).

Similarly predating RICO is the use of the phrase "directly or indirectly" to modify "participate." In the Securities Act of 1933, an "underwriter" is defined to include a purchaser/seller or any person who "participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . . ." 15 U.S.C. § 77b(11).<sup>13</sup> Such language was broadly

<sup>13</sup> In the same paragraph, Congress used the concept of "controlling" persons when it defined "issuer" to include any  
(Continued on following page)

construed, just before RICO's adoption, to reach "every person who participates in a distribution of securities," not just those "who are engaged in steps necessary" to the distribution. *Securities and Exchange Comm'n v. Van Horn*, 371 F.2d 181, 188 (7th Cir. 1966).

In short, when RICO was adopted, the words "participate" and "indirectly" had meaning in related contexts that suggested breadth, coverage, and extension of liability to secondary participants. To follow that tradition, RICO should cover a person who "shares" in a joint effort, provides "some aid," commits "some act," "engage[s] in some affirmative conduct," "in some sort associate[s] himself with the venture," or "give[s] assistance to the primary wrongdoer." To "participate," one need *not* be "engaged in steps necessary" but may be involved "to some lesser degree."

Returning then to question C, whether Arthur Young did "participate . . . indirectly, in" the conduct of affairs already described, we again stress that this is not a case of the typical auditor, who does nothing more than audit, and perhaps leave unchallenged, fraudulent materials invented and used by an issuer's management as part of their fraudulent scheme.

(Continued from previous page)

person "directly or indirectly controlling or controlled by the issuer." 15 U.S.C. § 77b(11). The words "controlling person" and "participant" apparently were viewed as discrete concepts. See *McCowan v. Sears, Roebuck and Co.*, 722 F. Supp. 1069, 1073-74 (S.D.N.Y. 1989).

Here Arthur Young was the prime mover. Arthur Young invented the fraud. Arthur Young alone decided to pretend that the Co-Op did not buy the gasohol plant, contradicting White's own lawsuit and all existing documents. Arthur Young alone invented the \$4.3 million "cost" figure, pretending that Drozal "independently" determined there were \$4.3 million in construction costs before 1981. Arthur Young alone decided to pretend (and tell the USDA) that an appraisal was "impossible" when the Board had already decided to get one (and had asked Arthur Young to help find an appraiser). Arthur Young alone decided to pretend (and tell the USDA) that an economic analysis was "impossible" when Arthur Young already had done one. Arthur Young alone decided to ignore that analysis, which required an immediate write-down, and pretend that a writedown was a subject for "future" consideration. Arthur Young alone decided not to apply "related-party transaction" procedures. Arthur Young alone persuaded a director to forget about \$150,000 a year in interest in order not to "open a can of worms" – the worms being fraud, falsification of records, perjury, and subornation by colleagues of Arthur Young. Arthur Young alone acted as spokesperson to the Co-Op's members and investors on financial matters and deliberately misled them at two annual meetings.

In all these decisions and actions, Arthur Young barely consulted management or the Board, perpetuating a fraud and coverup contrary to the very reason the "new" directors had sought election to the Board. (Trans. XII:188.) Let us consider, one by one, the only persons other than Arthur Young who *could* have "participated" in the conduct of the affairs described in (A) above.

Former chief executive White, though ready enough to lend his hand to a fraud, went to jail before Arthur Young drafted the first Co-Op financial report and statement. New chief executive Fred Howard was not hired until after the first audit was complete. When he was hired, he was, by agreement, held harmless from responsibility for financial records until the next audit was complete. That was done precisely because Howard was uninvolved in, and uninformed about, prior activities. As between chief executives and Arthur Young, then, the latter was plainly the primary participant.

Next, the closest thing to an internal chief financial officer, "office manager" Goradia, presents the simplest case. When asked, he actively refused, in writing, to accept any responsibility for the Co-Op's financial records or transactions. Arthur Young proceeded knowing of Goradia's disclaimer, which Arthur Young accepted.

Finally, there are the directors, whom Arthur Young met with and had a duty to consult. They were barely informed of anything. They were told the writedown issue was a "future" issue. They were discouraged from getting involved and opening a "can of worms."

In short, Arthur Young crossed the line. It stopped being an auditor and *de facto* made key decisions and took key actions to falsify the Co-Op's records, hide its insolvency, hide the frauds of third parties, fraudulently keep securities sales going, and mislead Co-Op members, Board, and management. Even if the typical (mere) auditor is not covered by RICO, plainly here a jury could find

that Arthur Young "participated," at least "indirectly" in the "conduct" of the "affairs" described in (A), above.

(D) It needs little further discussion to show that what has just been described as Arthur Young's "participation" in the "conduct" of "affairs" was done "through" the securities frauds found by the jury. Arthur Young's frauds were the means to distort the financials, conceal fraud and insolvency from the members, sell demand notes to unsuspecting investors, prevent a "run," and otherwise influence in a fundamental way how the Co-Op did business in a number of significant areas.

The Eighth Circuit and Judge Waters said nothing inconsistent with the above analysis. They drew a different conclusion not through a different analysis, but because they felt bound by an *en banc* opinion of the Eighth Circuit – as to which the trial court said, in granting Arthur Young summary judgment, it is "doubtful that R.I.C.O. questions could be raised against the work of auditors, based on *dicta* in *Bennett v. Berg*." (JA 2.)

Yet the same time the trial court reached this decision, it also recognized the distinct possibility that a jury could find Arthur Young *alone* had perpetrated the entire fraud. The trial court reasoned that Arthur Young could not escape liability under another fraud statute because to do so would mean auditors had effective immunity thereunder, and that was undesirable (CA 181 (emphasis in original)):

If the jury were to find . . . in 1982, that the only persons who were aware that the Co-op was actually insolvent were the accountants and, that out of a misplaced loyalty, the accountants

decided to distort the Co-op's true financial picture, knowing that people were actively investing in the enterprise: does it "make sense" that the only parties who could be held responsible under the law were the directors, whose intent was non-fraudulent? . . . The case against the directors would fall because they had no way of knowing (or suspecting) that accountants would perversely issue a deliberately distorted report . . . . The defrauded parties, under this restrictive view [that the state law does not reach auditors], could have no direct rights against the *only* parties responsible for the fraud.

The very thing the trial court refused to do on that other statutory claim, however, was exactly what the trial court felt compelled to do regarding RICO because of the stringent *Bennett* dictum.

## II. THE *BENNETT* DICTUM, WHICH EVOLVED WITH LITTLE ANALYSIS, CONFLICTS WITH THE WORDS, PURPOSE, AND REQUIRED "LIBERAL" CONSTRUCTION OF RICO.

The test formulated by the Eighth Circuit (and adopted in altered form by the D.C. Circuit) should be rejected, as it has been by other circuits (six of which have conflicting tests).<sup>14</sup> Only under this test is "conduct" construed to require the defendant to "control" (or "significantly control") the "management or operation" (or "direction" or "course of business") of an enterprise. This requirement (A) evolved with little explanation or analysis; (B) creates many new problems and solves none,

<sup>14</sup> See generally Douglas E. Abrams, *The Law of Civil RICO* § 4.7.3, at 232-42 (1991) (describing tests and collecting cases).

while obstructing the fundamental goal of RICO; and (C) is incompatible with statutory language.

**A. The "Control" Test Applied Below Evolved With Little Explanation Or Analysis.**

In *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008 (1983), residents of a retirement village asserted a claim under section 1962(c) against, *inter alia*, the mortgage lender to the village, the village's outside accountants, and in-house counsel for related corporations. The Eighth Circuit, sitting *en banc*, affirmed the dismissal of the complaint with leave to amend. The Eighth Circuit offered several "observations in the interest of aiding the district court and the parties on remand." One observation concerned the degree of participation necessary for liability under section 1962(c): "A defendant's participation must be in the conduct of the affairs of the enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." *Id.* at 1364. The Court said little about the traditional or customary meanings of any of the statutory terms and gave no effect to the important terms "participate" and "indirectly." It cited no legislative history or rules of construction. It modestly offered an "observation" on how cases "ordinarily" develop.

*Bennett* was described as a "restrictive" minority view but nevertheless was adopted in *Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 954 (D.C. Cir. 1990) (en banc), cert. denied, 111 S. Ct. 2839 (1991). *Yellow Bus* held that a union, "merely by conducting a recognition strike against an employer," could not be said to "participate" in the conduct of the employer's

affairs. *Id.* at 949, 955. Reaching this plainly sound conclusion required no reliance on *Bennett* (to which the *Yellow Bus* facts bore no resemblance). In its decision, the D.C. Circuit surveyed "divergent" interpretations and decided that *Bennett's* "operation or management" phrasing "hit closest to the mark." 913 F.2d at 952-54. The D.C. Circuit then modified this phrasing several times: first to "management or direction"; later to "guidance, management, direction or other exercise of control over the course of the enterprise's activities." *Id.* at 954.

The "control" language, thus introduced, began to accumulate its own gloss and, eventually, became the essence of the D.C. Circuit reasoning: "As the Eighth Circuit observed, most of the time this requirement will only be satisfied when the defendant, either directly or indirectly, exercises control over the management or operation of the enterprise." *Id.* at 954. Having turned "participation" into "control," the opinion became more restrictive, requiring the "control" to be "significant" and finally defining the "crucial question" as "whether and to what extent that person controls the course of the enterprise's business." *Id.* *Yellow Bus* does not discuss any case regarding, or customary definition of, the terms "participate," "indirectly," or "affairs."

In this case, the Eighth Circuit accepted the praise and description of *Bennett* in *Yellow Bus* (though it is unclear whether the court adopted all that *Yellow Bus* said); agreed with *Yellow Bus* that a majority of other circuits had rejected such a strict test; and then, without offering any defense, rationale, or explanation of *Bennett*, simply held that an Eighth Circuit panel was obligated to follow an earlier *en banc* opinion. In this fashion, without

any real analysis, the statutory phrase "participated, directly or indirectly, in the conduct of the affairs" evolved in two circuits into "exercised significant control over management or operations" or some variant of that.

**B. By Using Standards Not Based On Statutory Language, The Bennett Test Creates Many Insolvable Problems And Obstructs The Chief Purpose Of RICO.**

One is on no firmer ground with *Bennett/Yellow Bus* than with the statutory language. "Management" could mean only top management or also middle management. If the latter, then it may be enough to participate in only – for example – sales, finance, or pension investments, which seems contrary to the holding below. A "management" test does not explain how close a defendant must come to participating in *all* aspects of management. Similarly, "operations" could include production lines, quality control, or even maintenance. But if it is sufficient to participate in just these matters, there is no benefit in redefining "conduct," and such a redefinition does not limit RICO or warrant the result below. "Control" or "significant control" leaves open the issue "control over what." If one must control all operations, middle management seems excluded. If control must be complete, ultimate, or primary, that goes against the "sharing" and "aiding" ideas in "participate." But if control can be shared, partial, or incomplete, it adds nothing to the analysis to mention it.

Ultimately, of course, one must determine which statutory words support all these glosses in order to answer

the questions raised by them. But then we are back to the statute. A court cannot create a requirement not plainly explicit or implicit in statutory words. See *H.j. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 240-41 (1989) (rejecting "multiple scheme" requirement in part because its words "appear nowhere in the language" of section 1962(c)); *Sedima*, 473 U.S. at 495 ("[T]here is no room in the statutory language for an additional . . . requirement.").

Moreover, to the extent any of these glosses have meaning, they plainly push in the direction of confining RICO liability to inside management, top management, and daily managers. They tend to exclude those with outside, intermittent, and shared involvement over parts of operations. In short, they cut exactly against the grain of RICO, undermining the statute's essential purpose.

RICO, much criticized by judges, is beloved of legislatures. For twenty-two years Congress has refused to amend it despite ridicule and pleading by judges of all viewpoints. Meanwhile, numerous states have adopted versions of this criticized statute. State and federal government officials (see *amici* briefs in this case) alike support it and ask for its broad construction. RICO's uniquely draconian provisions and powerful incentives for "private attorney generals" obviously serve a purpose, the essence of which is to multiply the penalties and liabilities of ordinary crimes and torts when the wrongdoer commits his wrongs not just through his own individualized resources but by obtaining the additional resources that come from being able to influence a larger, ongoing, perhaps reputable enterprise.

These policies apply here. If Arthur Young wanted to cover-up White's frauds and defraud the public into continuing to finance the Co-Op for over two years, Arthur Young alone would find it difficult or impossible to do so. The massive fraud committed here on over a thousand persons for over two years could be accomplished only because Arthur Young was able to utilize the resources of the Co-Op – which had been in business since 1946, had thousands of members, enjoyed goodwill with potential notebuyers, had facilities in two states, and had an existing investment program with many actual and potential investors. Arthur Young was able to deceive so many persons for so long only because it could secure the benefit of the Co-Op's resources.

In other words, the *Bennett* test prevents coverage of the paradigm case that RICO seeks to target. It makes RICO inapplicable in the main situation where RICO is designed to apply. By confining "participation" to cases where, *e.g.*, a company president causes his own company to issue securities fraudulently, it confines RICO to situations where defendant uses the resources he already has at his command and does not involve the resources of any other enterprises by participating in their affairs through illegal acts.

### C. The *Bennett* Test Is Incompatible With Statutory Language.

A fatal flaw of the *Bennett* test is its incompatibility with several plain, statutory provisions and important applications of RICO such as bribery cases.

Congress included not just "management" but all "employees" of an enterprise under section 1962(c). To define "conduct" to exclude all employees not in management (and, especially, higher management) leaves no room for Congress' broad word to apply. *United States v. Garner*, 837 F.2d 1404, 1420 (7th Cir. 1987), *cert. denied*, 486 U.S. 1035 (1988) ("RICO does not require that the defendants actually manage or operate the enterprise. This court's decisions have held squarely that a RICO defendant need not have a supervisory position in order to violate section 1962(c)."); *Bank of America v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986) ("It is not necessary that a RICO defendant participate in the management or operation of the enterprise.")

Similarly, Congress included in section 1962(c) all persons "associated with" an enterprise. That is, it included specifically persons who were not employees and did not work full-time for the enterprise (such as auditors). *Bank of America*, 782 F.2d at 970. Nor did Congress require even such outsiders to be associated with top "management." *United States v. Yonan*, 800 F.2d 164, 167 (7th Cir. 1986) ("[T]here is no statutory requirement that . . . persons have contact with policymakers or heads of enterprises before they can be said, to be associated with it."), *cert. denied*, 479 U.S. 1055 (1987); *accord United States v. Mokol*, \_\_\_ F.2d \_\_\_, 1992 WL 49,796 (7th Cir. Mar. 18, 1992).

Indeed, to confine liability to those who manage the enterprise from inside or who have high-level positions with broad areas of control virtually eliminates RICO's coverage of bribery, which is a specific predicate act under RICO. In *Yonan*, a defense lawyer repeatedly

bribed a prosecutor (plainly committing a pattern of predicate racketeering acts). The Seventh Circuit held that he thereby violated section 1962(c) on "a common sense reading of the term that focuses on the business of the enterprise and the relationship of the defendant to that business." 800 F.2d at 165-67.

Obviously, the briber was not involved full-time with the prosecutor's offices and did not run many of its affairs. He certainly had no role in most cases the prosecutors settled and tried, in hiring and firing their secretaries, in administering their pension and insurance plans, in leasing space for their office, or in most of the office's activities. That will almost always be the case with bribers. To keep them under RICO, as Congress plainly intended, one must conclude that it is sensible usage to say that a briber "participates" in the "conduct" of the "affairs" of the bribee even though all the briber does is pay a series of bribes.

Indeed, the Court employed that usage in dictum in *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229 (1989). There, the defendant telephone utility allegedly bribed the state public utilities commission that set rates for numerous utilities, including the briber. After deciding a different issue, the Court noted that a section 1962(c) claim could be proven by demonstrating that bribes were the utility's "regular way of conducting or participating in the conduct of the" Commission. 492 U.S. at 250. Presumably when the Court made this statement there was no reason to think the utility had any more power than any typical briber to hire, fire, attend board meetings, supervise other matters, negotiate leases, handle insurance claims, or otherwise "control" or "manage" the

Commission's daily affairs in the way that, say, a vice-president would. The briber had only *de facto* ability to influence, and only as to one small portion of the Commission's total functioning, yet the Court naturally and without hesitation spoke of the briber "participating in the conduct of the" Commission through the bribes.<sup>15</sup>

Congress could not have meant to make bribery a predicate act and then adopt a "management-control" test that no briber could ever meet. That is why Congress chose the broad words "participate" and "indirectly," and the secondary-responsibility words "employees" and "associates," all of which traditionally do the job of extending coverage beyond primary, controlling, managing, and central persons.

Thus, the word "conduct," whether used as a verb or as a noun, simply cannot swallow every other word in the critical phrase "conduct or participate, directly or indirectly, in the conduct of the affairs of the enterprise." Even if "conduct" suggests an element of leadership, it must be flexible enough to be satisfied by a briber, by an employee who is not a member of top management, or by

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<sup>15</sup> Other RICO bribery cases show that other federal judges use the same language the same way. E.g., *United States v. Blackwood*, 768 F.2d 131, 138 (7th Cir.), cert. denied, 474 U.S. 1020 (1985) (defendant police officer held to "participate" in "conduct" of "affairs" of court when police officer attempted to influence the decision of cases through the solicitation of bribes, falsification of records, use of court offices, and contact with judges); *Mylan Lab., Inc. v. Akzo, N.V.*, 770 F. Supp. 1053, 1081-82 (D. Md. 1991) (drug firms bribed FDA); *United States v. Roth*, 669 F. Supp. 1386, 1388 (N.D. Ill. 1987) (attorney was unsuccessful in attempts to bribe judges).

a non-employee who simply is "associated" with the enterprise. The noun "conduct" must be something that can be "participated in," i.e., shared by several persons, some of whom only "aid" or "assist" the others. Further, the verb phrase "conduct . . . the affairs of the enterprise" (no matter how restrictively it is read) is separated by an "or" from the plainly more expansive noun phrase "participate . . . indirectly, in the conduct of the affairs of the enterprise." Thus, when all the key statutory terms are given life, it is plain that the single word "conduct" cannot be used to limit the reach of RICO to those with "significant control" over the fundamental direction of the entire enterprise.

### III. THERE IS A BETTER APPROACH THAN THAT OF BENNETT.

Like the *amici* supporting petitioners, we prefer all of the existing formulations of the courts of appeals to that of the Eighth Circuit. (Among these tests, we favor the Seventh Circuit test.)<sup>16</sup> Indeed, since petitioners prevail under all tests other than *Bennett*, we have no motive to be critical. Nevertheless, the available formulations, as they stand, depart too far from the statutory language for us to urge any of them on the Court. To a degree, they are

<sup>16</sup> *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987); *United States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988). Other tests include *United States v. Cauble*, 706 F.2d 1322 (5th Cir. 1983) (a variation of the Seventh Circuit's test, adopted by the Sixth Circuit), *cert. denied*, 465 U.S. 1005 (1984), and *United States v. Scotto*, 641 F.2d 47, 54-55 (2d Cir. 1980) (adopted by the Third and Ninth Circuits), *cert. denied*, 452 U.S. 961 (1981).

subject to some of the criticisms raised above against the *Bennett* test.

When RICO creates a new legal concept (such as "through a pattern of racketeering acts"), some judicial gloss may be essential to ensure uniformity of application. However, in those cases, it is hard to avoid using non-statutory words that are no easier to understand than the original statutory words. See *H.J. Inc.*, 492 U.S. at 251 (concurring opinion). Moreover, unless the new words are synonyms, in which case they accomplish little, there is an invariable change in meaning.

In the present case, the most important phrase ("participate, directly or indirectly") has traditional and accepted meanings in related contexts. The words "affairs" and "conduct" are both common and subject to limiting or certain definition. Thus, it may well be wise here to avoid trying to paraphrase the statute. Problems in interpreting the statutory language perhaps can more easily be solved by trial courts on a case-by-case basis, using traditional techniques of statutory construction. First, stipulations and partial summary judgments often can be used to pare away excess verbiage and substitute specific and concrete words for abstract terms in order to focus on what is really at issue. Then, the key terms can be defined, if necessary, using the same settled definitions that would be used in – for example – an aiding and abetting case or statutory securities violation involving the term "participate." Using this straight, statutory approach a trial court might proceed in four phases:

1. Determine whether there is a clearly-defined "enterprise" and whether it is involved in interstate commerce. If these issues are admitted, or so obvious as to be decided as a matter of law, the enterprise's name can be substituted in the issue analysis and the reference to interstate commerce omitted. (Here, for example, this can be done because the Co-Op is an enterprise in interstate commerce.)

2. Based on proof or concessions, it may be possible to drop "conducted or" and use only the "participation" clause. For summary judgment purposes, a court could focus on the "participation" clause on the theory that a plaintiff who cannot prove "participation" would ordinarily fail to prove whatever is required by the prior verb "conduct." The phrase "directly or indirectly" may often be irrelevant on the facts or something the parties might stipulate out of the case.

3. Determine the predicate acts in question and, if possible, whether as a matter of law they would (or would not) form a "pattern" if proved. Substitute those acts for the closing phrase in section 1962(c).

4. For "affairs" the court could consider substituting a concrete description of the portion of the enterprise's affairs that are in fact alleged (or *prima facie* shown) to be at issue.

Applying this approach in this case, for example, a special interrogatory to the jury could be as simple as: "Whether Arthur Young through a pattern of securities frauds participated in the conduct of the Co-Op's

demand note program." So reduced, the question is manageable and comprehensible, whether for summary judgment purposes or for a jury. Unlike the problem with the novel "through a pattern of racketeering" language at the end of section 1962(c), there is no pressing need to rephrase the familiar concepts in the "participation" portion of the statute. It does not help to add additional gloss, whether "control" and "management" (Eighth and D.C. Circuits), "enabled" and "involvement" (Second Circuit), or "facilitated" and "effect" (Seventh Circuit). Such words do not aid a jury, or a district judge, in analyzing the statutory requirements. But, worse, the tests raise more questions than the statutory language because their words use terms that do not have meanings as clear, settled, and customary as the words Congress chose.

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## CONCLUSION

The Eighth Circuit should be reversed. The case should be remanded to the district court for summary judgment proceedings or trial to determine whether Arthur Young, through a pattern of securities frauds, conducted or participated, directly or indirectly, in the conduct of the affairs of the Co-Op. The district court can

resolve that issue using whatever guides and interpretations the Court ultimately adopts.

Respectfully submitted,

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No. 64-686

Supreme Court, U.S.  
**FILED**  
NOV 29 1991  
CLERK OF THE COURT

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

BOB REVES, *et al.*,  
v. *Petitioners,*  
ERNST & YOUNG,  
*Respondent.*

On Writ of Certiorari to the  
United States Court of Appeals  
for the Eighth Circuit

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## QUESTIONS PRESENTED

1. Whether the court below was correct in affirming the district court's grant of summary judgment for respondent on petitioners' claim under the Racketeer Influenced and Corrupt Organizations Act on the ground that respondent, an independent public accounting firm, did not "conduct or participate, directly or indirectly, in the conduct of" the affairs of an alleged RICO enterprise within the meaning of 18 U.S.C. § 1962(c) merely by (1) performing audits of its client's annual financial statements, (2) meeting with the client's board of directors to explain the audits, and (3) making oral presentations at the client's annual meetings.

2. Whether petitioners' RICO claim must fail because of their inability to show that respondent's performance of two audits of its client's financial statements, in which it was found to have fraudulently overstated the carrying value of a single asset, satisfies RICO's requirement that the defendant have engaged in a *pattern* of racketeering activity.

## PARTIES TO THE PROCEEDING

In addition to the parties listed in the caption, Thomas E. Robertson, Jr., as Trustee of the Farmers Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, appeared in the proceedings below as a plaintiff/appellee and plaintiff/cross-appellant; and Robert R. Cloar, Class Counsel, was an appellant.

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## BRIEF FOR THE RESPONDENT

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### STATUTE INVOLVED

The pertinent provision of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962, is set forth in an appendix to this brief.

### STATEMENT

This case presents the question whether the Eighth Circuit was correct in affirming the district court's grant of summary judgment for respondent on petitioners' RICO claim. The essence of that claim is that respondent, an independent public accounting firm that issued audit opinions on the 1981 and 1982 financial statements of the Farmers Co-op of Arkansas and Oklahoma, Inc. ("Co-op"), participated in the conduct of the Co-op's affairs, and specifically its demand note program, through a pattern of racketeering activity consisting of securities fraud. The court of appeals held that respondent's activities, which consisted of performing audits of the Co-op's financial statements, meeting with the Co-op's board of directors to explain the audits, and making oral presentations at the Co-op's annual meetings, did not satisfy the "participation" requirement of 18 U.S.C. § 1962(c). J.A. 275.

Petitioners recognize that these activities are plainly insufficient to bring respondent's actions within the reach of Section 1962(c). *See, e.g.*, Br. 27 ("this is not a case of the typical auditor, who does nothing more than audit, and perhaps leave unchallenged, fraudulent materials invented and used by an issuer's management as part of their fraudulent scheme"); *see also id.* at 23-24, 29. Thus, petitioners devote virtually their entire brief to rearguing the merits of their securities law claims (which are not before the Court) in an attempt to demonstrate that what the courts below found to be auditing activity was not auditing activity at all. Petitioners' statement of the case improperly ventures far beyond the summary judgment

record<sup>1</sup> in an effort to establish that respondent "stopped being an auditor and *de facto* made key decisions and took key actions to falsify the Co-op's records, hide its insolvency, hide the frauds of third parties, fraudulently keep securities sales going, and mislead Co-op members, Board, and management." *Id.* at 29. As we show below, the decisions of the district court and the Eighth Circuit on a fully developed summary judgment record reveal these contentions to be false.

<sup>1</sup> It is well established that review of a grant of summary judgment is limited to an examination of the record before the district court at the time that its ruling was made. *See, e.g., Savers Fed. Savings & Loan Ass'n v. Retz*, 888 F.2d 1497, 1501 n.4 (5th Cir. 1989); *Frito-Lay, Inc. v. Willoughby*, 863 F.2d 1029, 1035-1036 (D.C. Cir. 1988); *Vontour v. Vitale*, 761 F.2d 812, 817 (1st Cir. 1985), *cert. denied*, 474 U.S. 1100 (1986). Petitioners attempt to justify their departure from this rule on the ground that:

After all trial evidence was admitted, plaintiffs moved for and the judge *granted* reconsideration of the pre-trial summary judgment on RICO issues. The trial court then reaffirmed its earlier ruling based on the combined trial and pre-trial record. (Trans. XV: 48-51.)

Br. 2 n.2 (emphasis added). This is not what happened. The transcript pages cited by petitioners reveal instead that the district court *denied* rather than granted petitioners' motion for reconsideration, and did so because it believed that submission of the RICO claim would prejudice the jury's consideration of the remaining claims. There is nothing to suggest that the district court assessed the evidence elicited at trial and determined that it fell short of what the "conduct" element of Section 1962(c) requires. Nor is there anything in the Eighth Circuit's opinion to suggest that it departed from fundamental principles of appellate review when it affirmed the district court's grant of summary judgment.

At bottom, much of the trial evidence on which petitioners improperly rely is simply an elaboration of the summary judgment evidence and to that extent petitioners' error may be harmless. What is not harmless, however, are petitioners' mischaracterizations of the trial record in an attempt to portray respondent as utterly corrupt. Accordingly, respondent believes that it is appropriate to correct at least the most serious misimpressions that petitioners have attempted to convey. However, matters that were not before the district court when it entered summary judgment are not properly before this Court and should not be considered.

1. *The Co-op and Its Demand Note Program.* This case arises out of the 1984 bankruptcy of the Co-op. The Co-op was organized in 1946 and was conducting extensive business operations in western Arkansas and eastern Oklahoma by the late 1970's. Beginning in 1959, the Co-op raised capital to support its general business operations by selling promissory notes payable on demand of the holder. These demand notes were uncollateralized and uninsured, but were attractive to investors because they paid a higher rate of interest than the rates offered by local financial institutions. J.A. 232.

The Co-op advertised the demand note program in its monthly newsletter. For many years that advertisement stated that "YOUR CO-OP has more than \$11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is \* \* \* Safe \* \* \* Secure \* \* \* and available when you need it." C.A. Jt. App. 1820 (ellipses in original). It is undisputed that respondent had no involvement with the Co-op's newsletter. Tr. Vol. X at 165.

It is also undisputed that respondent "played no active role in the purchase of demand notes." J.A. 307; *id.* at 150-167. In granting summary judgment to respondent on petitioners' claims alleging the sale of unregistered securities, the district court held that the record would not support a finding that respondent (i) was in privity with any of the demand note purchasers (J.A. 156); (ii) was "a substantial factor in causing any one sale to take place" (*ibid.*); (iii) "commanded, directed, advised or encouraged the sale of unregistered demand notes" (*id.* at 158); or (iv) conspired with others to sell the demand notes (*id.* at 159-163). According to the district court, "[t]he sales had been going on for two decades before any of these gentlemen arrived on the scene. The most that can be said is that they failed to advise against the sales." *Id.* at 158-159.

2. *Arthur Young's Audit Opinions.* Arthur Young & Company was first retained as the Co-op's independent

auditor in 1981.<sup>2</sup> It subsequently issued audit reports on the Co-op's financial statements for the years ending December 31, 1981 and December 31, 1982. Upon assuming its duties as the Co-op's auditor, Arthur Young was required to address a number of accounting issues. One major issue—and the principal basis for petitioners' securities fraud claims—related to the appropriate basis of accounting for a gasohol plant that was owned by the Co-op through its wholly-owned subsidiary, White Flame Fuels, Inc. ("White Flame").

In 1979, the Co-op's general manager, Jack White, had joined with another individual to finance and construct the gasohol plant. Each invested \$125,000 of his own funds and acquired 50% of the stock in White Flame. Construction of the plant began in June 1979. Four months later, White purchased the other 50% interest in White Flame. Beginning in January 1980, White arranged for White Flame to obtain loans from the Co-op to finance the continued construction and the initial operation of the plant. White personally guaranteed these loans. The plant began producing gasohol in April 1980, but was soon beset by problems stemming from its poor design and from economic factors such as the falling price of oil. White Flame continued to obtain loans from the Co-op to cover the plant's operating costs. By December 1980, the loans totalled approximately \$4 million. Eventually, the Co-op's board of directors voted to purchase all of the stock of White Flame in exchange for the Co-op's assumption of White's \$4 million debt. J.A. 233-235.

The proper accounting treatment for the gasohol plant depended on whether the Co-op had in substance owned the plant from the beginning of its construction. If so, the plant could be carried at historical cost, approximately \$4.5 million. If not, the proper carrying value would have

<sup>2</sup> In 1989, Arthur Young and Ernst & Whinney combined to form the firm of Ernst & Young, which is the respondent in this case. Because the events at issue occurred prior to 1989, we will refer to respondent as Arthur Young.

been the fair market value of the plant at the time of transfer, which subsequently was estimated to have been between \$444,000 and \$1.5 million. J.A. 242, 245 & n.7. Although the stock of White Flame was originally owned by White and his partner, Arthur Young concluded that the correct accounting treatment under generally accepted accounting principles ("GAAP") was for the Co-op to carry the plant at its historical cost of \$4.5 million because in substance the Co-op had owned the plant from its inception: it had been constructed primarily with funds borrowed from the Co-op and was built by Co-op employees. *Id.* at 243; Tr. IX at 224, 225-226.<sup>3</sup> Because the Co-op's balance sheets for 1981 and 1982 reflected a net worth of only \$2.6 million and \$1.3 million, respectively, carrying the plant at a fair market value of \$1.5 million or less instead of historical cost of \$4.5 million would have resulted in the Co-op's balance sheets showing a negative net worth. J.A. 245.

Petitioners fail to point out that, although Arthur Young concluded that recording the gasohol plant at its historical cost was appropriate under GAAP, it also concluded, because of uncertainty over the recoverability of the cost of the plant, that it could not express an opinion on whether carrying the plant at historical cost fairly presented the financial condition of the Co-op. Arthur Young therefore issued *qualified opinions* on both the 1981 and 1982 financial statements. The 1981 audit report stated (J.A. 246; C.A. Jt. App. 235):

As discussed in Note 9 to the consolidated financial statements, there is some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations. Man-

<sup>3</sup> Petitioners' accounting expert testified at trial that it is a fundamental principle of accounting that the treatment of a transaction should reflect its economic substance (Tr. Vol. XIV at 245-246), and that in determining the carrying value of the gasohol plant he too had looked beyond the legal form of the Co-op's acquisition of the plant to assess the economic substance of the transaction. *Id.* at 246-247.

agement has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statements.<sup>[4]</sup>

The audited financial statements also revealed other negative information concerning the Co-op's financial condition. In particular, they indicated that the Co-op's current liabilities were approximately double its current assets and that the Co-op had suffered net losses of \$1.4 million in 1981 and \$1.2 million in 1982. C.A. Jt. App. 238-240, 261-263. Arthur Young presented its audit reports to the Co-op's board of directors, thus putting the board on full notice of the Co-op's deteriorating financial condition. See pp. 10-11, *infra*.

<sup>4</sup> Footnote 9 to the Co-op's 1981 financial statements addressed the accounting for the gasohol plant and the economic prospects of the Co-op (J.A. 247; C.A. Jt. App. 251-252):

Financing of the initial construction and subsequent major revisions which totaled approximately \$4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately \$5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging \$100,000 per month) until such time that improvements in marketing conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investment in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

Arthur Young's audit report on the Co-op's 1982 financial statements contained the same qualification as its 1981 report, and the 1982 financial statements themselves, in footnote 8, provided updated information on White Flame's worsening financial condition and the resulting uncertainty about the Co-op's ability to recover its investment. J.A. 255-256; C.A. Jt. App. 258, 272-273.

3. *Petitioners' Allegations of Respondent's Participation in the Conduct of the Co-op's Affairs.* Relying in large part on evidence adduced at trial (see note 1, *supra*), petitioners contend that respondent's activities included more than merely auditing the Co-op's financial statements. Petitioners' central thesis is that Arthur Young engaged in a series of frauds all intended to shield Jack White (who had been instrumental in the Co-op's decision to hire Arthur Young as its auditor) from scrutiny for prior misdealings with the Co-op. Petitioners' premise is wholly illogical and flies in the face of the evidence in several respects. What petitioners have failed to disclose bears emphasis here: *first*, that on a whole series of audit conclusions reached by Arthur Young—conclusions that revealed the Co-op's financial position to be far worse than Jack White wished it to be—White vehemently disagreed with Arthur Young;<sup>5</sup> and *second*, that Arthur Young also brought instances of White's suspected self-dealing to the attention of the Co-op's board.<sup>6</sup> Against this backdrop, we address the four areas in which petitioners contend that Arthur Young's conduct went beyond mere auditing.

a. *The Creation of Financial Data and Records.* There is no record support for petitioners' contention (Br. 23-

<sup>5</sup> The most significant dispute concerned the proper balance sheet classification of the demand notes. Prior auditors had permitted the Co-op to classify only 20% of the outstanding demand notes as current liabilities (liabilities payable within one year) on the theory that many note holders elected not to demand payment on their notes during the course of a year. C.A. Jt. App. 287, 296. Arthur Young concluded that this treatment violated GAAP and indicated that it would take exception to it in its 1981 report. Ultimately, all of the demand notes were classified as current liabilities. As a result of this and other disputes, White unsuccessfully sought to fire Arthur Young and to have another accounting firm conduct the audit of the Co-op's 1981 financial statements. *Id.* at 301.

<sup>6</sup> For example, White sought to claim the cash value of life insurance policies owned by the Co-op and to obtain payments for certain properties that he previously claimed to have contributed to the Co-op. Arthur Young brought these matters to the attention of the board of directors, which ultimately acceded to White's demands on both issues. Tr. Vol. X at 162-164; Tr. Vol. XI at 178-179.

24) that Arthur Young created "fundamental financial data" and used it "to prepare books, records, and financial statements." Although Arthur Young drafted the financial statements of the Co-op, the draft financial statements were based on the records maintained by the Co-op itself or its subsidiary, White Flame Fuels. Tr. Vol. IX at 180-185, 225-232, 236-239; Tr. Vol. X at 172-185.<sup>7</sup> Drafting a client's financial statements is in full accord with generally accepted auditing standards ("GAAS"), which were before the district court when it granted Arthur Young's motion for summary judgment.<sup>8</sup> Arthur Young created no other Co-op documents. It is undisputed that Arthur Young's role as the Co-op's audi-

<sup>7</sup> See also Appendix and Exhibits to the Reply Memorandum of the Arthur Young Defendants in Support of Their Motion for Summary Judgment, Nos. 85-2404, 2096, 2155 & 2256 (W.D. Ark. filed September 15, 1986) ("Reply Mem. Exhibits"), Vol. I at 12. Ironically, petitioners' contention that Arthur Young "creat[ed] fundamental financial data" (Br. 23) is wholly undercut by their citation to the district court's opinion (Br. 13, quoting J.A. 140-141) finding, in connection with petitioners' common law fraud and negligence claims, that it was not plausible to suppose that Arthur Young could have "independently" arrived at a cost of construction for the gasohol plant of \$4,393,242.66—the exact same figure arrived at by the Co-op's former internal accountant, Gene Kuykendall. Thus, whether the figure was right or wrong, it was "created" not by Arthur Young but by the Co-op's internal accountant.

Similarly, petitioners are wrong in asserting (Br. 9) that the decision on how to value the gasohol plant was made "unilaterally" by Arthur Young. Arthur Young's audit judgments were reached after consultation with Jack White, Kirit Goradia, the Co-op's chief financial officer, and individuals who had worked at the plant. Tr. Vol. IX at 227-229. Goradia, among others, agreed with the way in which the plant was valued in the Co-op's financial statements. Tr. Vol. X at 21-23, 172-185.

<sup>8</sup> Reply Mem. Exhibits, Vol. I at 12. The applicable professional standard provides in relevant part that while "[t]he financial statements are management's responsibility \* \* \* [t]he independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management's accounting system." [1 CCH] AICPA, *Professional Standards*, Statements on Auditing Standards ("SAS") No. 1, AU § 110.02 (emphasis added).

tor was to examine its client's records, to subject them to test procedures where circumstances warranted, and to reach accounting judgments based on the records and the data they contained.<sup>9</sup> There is no evidence that Arthur Young departed from this role in auditing the Co-op's financial statements.

b. "*Absentee Management*." Petitioners strive mightily to create the impression that the Arthur Young audit engagement team constituted the *de facto* management of the Co-op. In fact, during all relevant times, the Co-op had its own management team in place. During the 1981 audit, Jack White and Kirit Goradia were, respectively, the general manager and chief financial officer of the Co-op. Tr. Vol. IX at 166.<sup>10</sup> Petitioners again distort

<sup>9</sup> The summary judgment record contained the deposition testimony of petitioners' accounting expert that an auditor begins his examination based on the data recorded in the audit client's records, and then performs whatever special procedures he believes necessary with respect to that data. Reply Mem. Exhibits at 12. At trial, petitioners' expert testified that the Arthur Young auditors placed little reliance on the internal accounting controls of the Co-op and conducted a substantial amount of substantive audit testing, particularly in confirming the demand notes reported outstanding on the Co-op's books and in testing inventory compilation—two areas in which the Co-op's general manager, Jack White, had been accused of fraud. Tr. Vol. XIV at 241-242.

<sup>10</sup> White's conviction for tax fraud involving self-dealing with the Co-op does not change the fact that he was nonetheless the Co-op's general manager until the Board removed him in 1982. His conviction simply required Arthur Young to engage in substantially more extensive testing of the Co-op's books and records than might otherwise be the case. The record reflects that Arthur Young did exactly that. See n.9, *supra*; Tr. Vol. X at 157-158, 170-172; Tr. Vol. XI at 154-157, 186-187.

Similarly, Goradia's failure to sign the management representation letter in 1982 does not negate the fact that he was still the Co-op's chief financial officer. (Among other things, Goradia was the person who prepared the Co-op's condensed financial statements for distribution at its annual membership meetings. See pp. 12-14, *infra*.) The Co-op's general manager at the time of the 1982 audit, Fred Howard, signed the letter. J.A. 254. Accordingly, Arthur Young did not view Goradia's failure to sign the letter as a refusal

the record in contending (Br. 29) that White "went to jail before Arthur Young drafted the first Co-op financial report and statement." As petitioners acknowledge, White went to prison in April 1982 (Tr. Vol. XII at 25) and the uncontested testimony at trial established that a draft of the Co-op's 1981 financial statements was completed by mid-March 1982 (Tr. Vol. X at 33). During the 1982 audit, Fred Howard had replaced Jack White as general manager, and Arthur Young consulted with Howard regularly thereafter. Tr. Vol. X at 137-139. In the course of their work, Arthur Young's auditors reviewed and explained the Co-op's financial statements and Arthur Young's audit reports to the Co-op's management before they were submitted to the board of directors for approval. Tr. Vol. X at 35-36.

*c. Arthur Young's Meetings with the Co-op's Board of Directors.* Continuing on with their theme that Arthur Young somehow took over the Co-op, petitioners contend (Br. 18) that "Arthur Young met the directors, handed them a report, and tried to hurry them to approve it," clearly implying that Arthur Young failed to inform the Co-op's board of the financial problems that faced the Co-op, and specifically the problems posed by the gasohol plant. That contention too is belied by the record, which demonstrates that even though Arthur Young did not specifically describe the accounting principle used to report the cost of the gasohol plant, it clearly disclosed to the board the financial drain on the Co-op that the plant represented, the serious doubts that existed as to the recoverability of the Co-op's investment in the plant, and other major financial problems facing the Co-op. These meetings occurred on April 22 and July 1, 1982 and lasted for a total of five and one-half hours. Tr. Vol. XI at 203, 248-249; C.A. Jt. App. 434-437.

by "management" to sign the representation letter, especially because the Arthur Young auditors had confidence in Fred Howard, with whom they had frequent discussions concerning the Co-op. Tr. Vol. X at 138-139; Tr. Vol. XI at 185. (Arthur Young mistakenly believed that it had secured a management representation letter with respect to the 1981 audit. J.A. 255 n.10.)

During its April 22, 1982 meeting with the board, Arthur Young reviewed its audit report in detail. Tr. Vol. XI at 200-203; Tr. Vol. XII at 101. This review included the footnote disclosures concerning the gasohol plant. C.A. Jt. App. 250-252; Tr. Vol. X at 111, 200-205. Arthur Young discussed the recoverability problem with the board, indicating not only that the plant might at some point need to be written down, but also that the Co-op would be required to (i) obtain projections and analyses concerning the future use of the plant from qualified specialists (C.A. Jt. App. 235, 250-252; Tr. Vol. XI at 175-176, Tr. Vol. XII at 31-36), and (ii) obtain an appraisal of the plant's worth based on those projections and analyses. C.A. Jt. App. 235, 250-252; Tr. Vol. X at 193-96, 200-206. The board was informed that the Co-op had no basis to write down the plant's value in the absence of the needed data. C.A. Jt. App. 235, 250-252; Tr. Vol. X at 193-196. Arthur Young also explained the perils of relying on the demand note program for financing and urged the board to restructure its debt by obtaining longer term financing. Tr. Vol. IX at 187-88; 192-93; Tr. Vol. X at 95, 166, 207-208. Arthur Young believed that these problems were understood by the board (Tr. Vol. XI at 228-229), and when its meetings with the board concluded, according to the testimony of one of the directors, there were no questions left. Tr. Vol. XI at 203-204; Tr. Vol. XII at 31-35, 40-41.

*d. The 1982 and 1983 Annual Meetings and the Condensed Financial Statements.* The final way in which petitioners contend that Arthur Young supposedly strayed beyond the role of an auditor involves nothing more than Arthur Young's attendance at the Co-op's annual membership meetings to comment on financial matters. See Br. 24. An auditor's attendance at his client's annual meetings for such purposes is, of course, a routine matter that is an entirely logical follow-up to the audit engagement itself. See p. 41, *infra*. In any event, petitioners' account of Arthur Young's brief appearances at the 1982 and 1983 annual meetings is incomplete. The full record reveals the following information.

Representatives of Arthur Young made oral comments on the financial condition of the Co-op at its annual meetings in May 1982 and March 1983. At these meetings, condensed financial statements prepared by the Co-op's management were distributed to the audience. At the beginning of their oral presentations, Arthur Young's representatives informed the members of the audience that they had received only condensed financial statements and that copies of the full audited statements were available at the Co-op's offices. J.A. 250, 258. The condensed financial statements did not include the qualifications in Arthur Young's audit reports or the footnote disclosures concerning the gasohol plant. *Id.* at 249, 258.

The condensed statement of operations handed out at the 1982 meeting did not incorporate the gasohol plant operations and therefore reflected a net profit of \$154,000. C.A. Jt. App. 231. The condensed balance sheet included the gasohol plant valued at historical cost and therefore reflected net members' equity of \$2.6 million. J.A. 249. During the course of the oral comments by Arthur Young's representative, the audience soon began asking questions concerning White Flame and its financial status. Petitioners err in asserting (Br. 16-17) that Arthur Young's representative "corrected no errors and evaded all questions."<sup>11</sup> During these interchanges, White

<sup>11</sup> Petitioners also misstate the record in claiming (Br. 16) that "Arthur Young knew at that time that the condensed financial statements were misleading \* \* \*." The record is clear that Arthur Young's representative at the meeting, Harry Erwin, had Arthur Young's full audit report with him, had received the condensed financial statements only when he arrived at the meeting, and had no advance preparation as to the condensed statements' contents. J.A. 250; Tr. Vol. XII at 107. The testimony cited by petitioners (Tr. Vol. XI at 125, 146-147) relates to the observation of an Arthur Young representative, Mr. Cabaniss, concerning the condensed statements to be presented at the 1983 annual meeting. Cabaniss testified that he realized the condensed statements presented at the 1982 meeting were misleading only *after* the meeting had occurred. Tr. Vol. XI at 101. In preparation for the 1983 meeting, Cabaniss therefore informed the Co-op's general manager, Fred Howard, that condensed statements would be misleading without Arthur Young's full report and footnote disclosures. Tr. Vol. XI at 147-148.

Flame's \$1.2 million loss in 1981 was disclosed to the audience. J.A. 250-251. Arthur Young's representative also disclosed: (i) that the Co-op's condensed statements did not include the \$1.2 million loss (Tr. Vol. XII at 108-09); (ii) that the net worth of the Co-op had fallen \$1.8 million over the previous year (Tr. Vol. XII at 109); and (iii) that the Co-op had invested more than \$4 million in the gasohol plant by the end of 1980, and that figure had risen to approximately \$5 million by the end of 1981. Tr. Vol. XII at 133.

In advance of the 1983 annual meeting, the Co-op's general manager, Fred Howard, suggested distributing Arthur Young's audit report, including the Co-op's financial statements, to attendees at the 1983 meeting, but without the footnote disclosures concerning the gasohol plant. Arthur Young informed Howard that the financial statements would be misleading without the footnotes and instructed him that Arthur Young's report and the accompanying financial statements should not be condensed. Tr. Vol. XI at 147-148; 225-227. Arthur Young also informed Howard and Kirit Goradia that Arthur Young's name should not appear on any condensed financial statements because such statements would not be Arthur Young's, and that the proper course was to provide the meeting attendees with Arthur Young's report and a complete set of financial statements, including the footnotes. J.A. 257; Tr. Vol. X at 123; Tr. Vol. XI at 148, 225-226. The Co-op's management did not follow Arthur Young's advice: shortly before the 1983 meeting, Arthur Young's representative received a copy of the Co-op's condensed statements, which indicated that the information was condensed from Arthur Young's report. J.A. 257. At the meeting, Arthur Young's representative again informed the audience that the full audited financial statements were available at the Co-op's offices. J.A. 258.

Although the condensed financial statements distributed by the Co-op at the 1983 meeting did present more completely the Co-op's rapidly worsening financial condition, they again omitted the qualification in Arthur Young's audit opinion and the footnote disclosure on the gasohol

plant. J.A. 258. The condensed statement of operations for the 1983 annual meeting did include the gasohol plant and reflected losses of \$1.4 million in 1981 and \$1.2 million in 1982. C.A. Jt. App. 233. In addition, the balance sheet reflected current assets of only \$6.9 million to cover current liabilities of \$15.3 million. *Id.* Net members' equity had dropped from \$2.6 million to approximately \$1.4 million. *Id.*

4. *The Proceedings Below.* In February 1984, the Cooperative Finance Association ("CFA") refused to advance additional funds on a line of credit it had provided to the Co-op because the level of demand note financing had dropped slightly below the amount required by the terms of the credit agreement. CFA's denial of additional credit forced the Co-op to file for bankruptcy. J.A. 259-260. Less than a year later, the Co-op's bankruptcy trustee filed an action in the United States District Court for the Western District of Arkansas on behalf of the Co-op and certain demand note holders against forty individuals and entities, including Jack White, members of the Co-op's board, several of the Co-op's lawyers, Arthur Young, and the two auditors that had preceded Arthur Young. The complaint alleged a wide variety of federal and state causes of action, including common law fraud and negligence, violations of the registration and disclosure provisions of the Arkansas Securities Act, violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, violations of the registration provisions of the Securities Act of 1933, and violations of RICO, 18 U.S.C. §§ 1961-1968. Subsequently, the district court certified a plaintiff class consisting of persons who purchased demand notes between February 15, 1980, and February 23, 1984. J.A. 262.

Petitioners alleged in their complaint that Arthur Young had conducted or participated in the conduct of the affairs of the Co-op through a pattern of racketeering activity consisting of mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c). J.A. 273-274. After the close of discovery, Arthur Young moved for summary

judgment on this claim, urging two grounds: first, that petitioners could not establish that Arthur Young had conducted or participated in the conduct of the Co-op's affairs within the meaning of Section 1962(c); and, second, that petitioners could not demonstrate that Arthur Young had engaged in a pattern of racketeering activity as required by the statute. J.A. 198. The district court granted Arthur Young's motion, holding that under the Eighth Circuit's decision in *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), *cert. denied*, 464 U.S. 1008 (1983), mere participation in auditing activities is insufficient to constitute participation in the conduct of the affairs of a RICO enterprise under Section 1962(c). The district court held (J.A. 199-200):

Plaintiffs have failed to show anything more than that the accountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceeding (*sic*) the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by *Bennett v. Berg*, *Id.*<sup>12</sup>

Prior to trial, all defendants except Arthur Young and White's lawyers settled the claims against them. J.A. 262. (White's lawyers settled after trial. J.A. 262 n.13.) After a month-long trial, the jury found that Arthur

<sup>12</sup> Petitioners also argued to the district court that the Arthur Young auditors had operated *Arthur Young* through a pattern of racketeering activity. J.A. 211-212. Under this theory Arthur Young, rather than the Co-op, was the alleged RICO enterprise. The district court rejected that contention, noting that while the individual Arthur Young auditors had obviously participated in the management of Arthur Young, there was no proof that Arthur Young's "affairs" had been conducted through a pattern of racketeering activity. The court noted that to the extent Arthur Young's dealings with the Co-op were wrongful, "such dealings are aberrant, and in no way 'typical' of the practice of these professionals." *Id.* at 212-213. Petitioners did not appeal that determination to the Eighth Circuit, and it is not an issue before this Court.

Young had committed primary violations of Section 10(b) and secondary violations of the Arkansas securities statute. J.A. 265. The jury rejected the Trustee's claim that Arthur Young was guilty of fraud in the performance of the audits. J.A. 265 n.15. On the Trustee's negligence claim, the jury found that Arthur Young was guilty of negligence in the performance of the Co-op's audits, but also found that the Co-op "was guilty of contributory negligence which interfered with Arthur Young's audit and which caused proximate damages to the Co-op" J.A. 265 n.15; Tr. Vol. XX at 5-6. The jury apportioned 50% of the responsibility to Arthur Young and 50% to the Co-op, which barred recovery under Arkansas law. *Id.* at 6.

Both Arthur Young and petitioners appealed the district court's judgment to the United States Court of Appeals for the Eighth Circuit. In its first opinion in this case, the court of appeals held that the demand notes were not securities under federal and Arkansas law and reversed the district court's judgment. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). This Court granted certiorari and reversed the judgment of the Eighth Circuit, holding that the demand notes were securities under federal law. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

On remand, the court of appeals concluded that the demand notes were securities under Arkansas law as well and affirmed the district court's judgment that Arthur Young had committed primary violations of Section 10(b) and was secondarily liable for violations of the Arkansas Securities Act. The court of appeals also affirmed the district court's grant of summary judgment to Arthur Young on petitioners' RICO claim. Viewing the evidence in the light most favorable to petitioners, J.A. 274, the court held that Arthur Young's involvement with the Co-op did not rise to the level of participation in the conduct of the Co-op's affairs required under Section 1962(c). On that issue, the court applied its prior ruling in *Bennett*, in which it had stated that "[a] defendant's

participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." J.A. 275 (quoting *Bennett*, 710 F.2d at 1364). Recognizing that "Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings," J.A. 275, the court of appeals concluded that that activity fell short of what *Bennett* requires.

### SUMMARY OF ARGUMENT

Both courts below unequivocally held that Arthur Young's activities as the Co-op's independent auditor in no way rose to the level of participation in the operation or management of the Co-op and therefore did not constitute participation in the conduct of the Co-op's affairs. Petitioners and their amici vigorously attack the Eighth Circuit's "operation or management" test, yet they are singularly unsuccessful in their efforts to propose a viable alternative. All of the proposed tests suffer from inherent flaws—some are clearly incorrect because they effectively eliminate key portions of the statutory language; others are of no use because they merely substitute one set of dictionary definitions for another. At bottom, all of these tests are simply an appeal to let prosecutors and juries decide RICO's coverage on an *ad hoc* and subjective basis, a state of affairs that would not pass constitutional muster.

In the end, like petitioners and the Government, we are unable to suggest any bright-line test that will, in all cases, provide meaningful guidance for determining at what point the activities of independent providers of services (or goods) to a legitimate company rise to the level of participation in the conduct of the company's affairs. What we *can* say, however, is that the Eighth Circuit's operation or management test is faithful to the statutory language and purpose and provides reasonable guidelines for interpreting the statutory language in the

specific context of independent auditors. However it may apply across the board, the Eighth Circuit's test excludes outside accountants who limit their involvement with a client to traditional auditing activities. Thus, the Court can easily dispose of this case by affirming the straightforward ruling of the court of appeals on this issue.

Alternatively, the Court could affirm the judgment below on the basis that respondent's audits of the Co-op's 1981 and 1982 financial statements did not, as a matter of law, constitute a "pattern of racketeering activity" under RICO. Respondent presented the "pattern" argument to both courts below, but neither court found it necessary to address the point because of their conclusion that the "conduct" requirement had not been satisfied. Nonetheless, the gravamen of petitioners' securities fraud claims is that Arthur Young fraudulently overstated the carrying value of a single asset of a single company in its first year of auditing, and then simply repeated the same mistake the following year. That claim lacks the essential element of "continuity" that is required by RICO and this Court's precedents.

If, however, the Court is not satisfied with either of these limited holdings and wishes to articulate a more comprehensive rule, we respectfully submit that it will find itself left with little choice but to conclude that RICO's conduct requirement, like other parts of the statutory language, defies every attempt to develop reasonable guidelines that comprehensively distinguish between conduct that was intended to be covered by RICO's draconian sanctions and conduct that was intended to be excluded. In the final analysis, therefore, the more appropriate alternative may be the one suggested by Justice Scalia in his concurring opinion in *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 254-256 (1989). If the Court were to strike down Section 1962(c) as unconstitutionally vague, Congress might at last be persuaded that persons of ordinary (and even extraordinary) intelligence have been left to guess at RICO's intended meaning for far too long.

## ARGUMENT

### I. THE COURT OF APPEALS CORRECTLY RULED THAT LIABILITY UNDER U.S.C. § 1962(c) REQUIRES SOME PARTICIPATION IN THE OPERATION OR MANAGEMENT OF THE RICO ENTERPRISE

#### A. The Standard Applied By The Court Below Is Not "Control" But Rather "Some Participation In The Operation Or Management" Of The RICO Enterprise

Respondent submits that the issue before the Court is narrow: whether an independent public accounting firm "conduct[s] or participate[s], directly or indirectly, in the conduct of" the affairs of an alleged RICO enterprise within the meaning of 18 U.S.C. § 1962(c) merely by engaging in audits of its client's annual financial statements and activities relating thereto (in this case, meetings with the client's board of directors and presentations at annual membership meetings). In concluding that as a matter of law there was no violation of RICO on these facts, the Eighth Circuit held that "[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." J.A. 275, quoting *Bennett*, 710 F.2d at 1364.

Petitioners and their amici largely ignore this holding and instead mount an attack on a quite different standard, "control," which they derive from *Yellow Bus Lines, Inc. v. Drivers Local Union 639*, 913 F.2d 948 (D.C. Cir. 1990) (en banc), cert. denied, 111 S. Ct. 2839 (1991). Indeed, according to petitioners and the United States, the question presented is whether the Eighth Circuit erred in requiring "proof that the defendant control the management or operation of the enterprise." Pet. Br. i (emphasis added); U.S. Br. I; see also Pet. Br. 19, 31; U.S. Br. 7, 9. That language is nowhere to be found in the Eighth Circuit's opinion in this case or in its prior decision in *Bennett*.

Ultimately then, all references to "significant control," "running the show" and "corporate boardrooms" (U.S. Br. 11-12; Pet. Br. 31, 33-34) as the Eighth Circuit's supposed prerequisites to liability under Section 1962(c) are a red herring. The Eighth Circuit did not require any such showing, but only evidence of "some participation in the operation or management of the enterprise itself" (J.A. 275, quoting *Bennett*).<sup>13</sup> The pivotal question here is whether that standard comports with the language, structure, and purpose of Section 1962(c).

**B. The "Operation Or Management" Test Is Faithful To The Language, Structure, And Purpose Of Section 1962(c)**

Perhaps because petitioners and their amici misinterpret the Eighth Circuit's "operation or management" test as a "control" test, they contend that it is incompatible with the statutory language and legislative purpose. As we show below, that is not the case.

1. *The Statutory Language.* In construing the meaning of the "conduct" requirement, it is appropriate to begin with the language of the statute itself, *H.J. Inc.*, 492 U.S. at 237, and to construe that language in accordance with its "ordinary meaning." *Russello v. United States*, 464 U.S. 16, 21 (1983). The statutory language should also be examined in light of its context and the structure of the statute as a whole. *King v. St. Vincent's Hospital*, 112 S. Ct. 570, 574 (1991).

<sup>13</sup> In its summary judgment opinion, the district court used the word "control," but then clearly applied the "operation or management" standard of *Bennett*, which contains no reference to "control." J.A. 199. On appeal, the Eighth Circuit applied the *Bennett* standard. J.A. 275. Although the court of appeals characterized *Yellow Bus* as adopting the Eighth Circuit's standard (J.A. 276), there is no reason to believe, as petitioners suggest (Br. 32-34), that the Eighth Circuit substituted the language of the *Yellow Bus* court for its own ruling in *Bennett*. Indeed, petitioners concede (Br. 33) that "it is unclear whether the court adopted all that *Yellow Bus* said," and the Government ultimately concludes (despite its frequent references to "control") that *Yellow Bus* "appears to be even more restrictive than the Eighth Circuit's test." U.S. Br. 11 n.9.

Respondent agrees with petitioners and their amici that, to the extent its meaning can be deciphered, "conduct" as used in Section 1962(c) includes more than "control." That conclusion is based on dictionary definitions of "conduct" that appear to encompass more than the ability to control or direct the affairs of an enterprise (see U.S. Br. 10-11; Pet. Br. 22 n.12)<sup>14</sup> and on the congressional "admonition that RICO is to 'be liberally construed to effectuate its remedial purposes.'" *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 498 (1985) (quoting Pub. L. No. 91-452, § 904(a), 84 Stat. 947).

Beyond that, however, the statutory language is utterly vague, as evidenced by the multiplicity of standards adopted by the courts attempting to interpret the conduct requirement and by the divergent tests offered by petitioners and their amici. See pp. 25-29, *infra*. Petitioners assert that the language is plain (Br. 41) and join the Government in contending (Pet. Br. 23 n.12; U.S. Br. 16) that "conduct" means merely "carrying on" or "carrying out" the affairs of the enterprise. But that formulation simply substitutes one dictionary term for another—an approach that petitioners themselves admit (Br. 41) is not helpful. In the end, both petitioners (Br. 43) and the Government (Br. 17, 18-19) acknowledge that a definitive test of "conduct" eludes their grasp—as it does ours.

But even if substituting "carrying out" for "conduct" provided meaningful guidance in delineating the reach of

<sup>14</sup> Although dictionaries are of course an oft used tool in statutory construction, we doubt their utility in this case. Depending on the dictionary consulted and the particular definition chosen, it is possible to define "conduct" in a manner that would support virtually every interpretation of Section 1962(c) that has ever been put forward. We therefore see little purpose to engaging petitioners and their amici in a "battle of the dictionaries." As we demonstrate in text (see pp. 20-22, *infra*), the Eighth Circuit's "operation or management" test is perfectly consonant with the broad dictionary definition of "conduct" contained in the *Oxford English Dictionary* and advocated by the Government.

the statute (and we submit that it does not), that would not mean that the Eighth Circuit's standard is wrong. For the operative phrase utilized by the Eighth Circuit—"some participation in the operation or management of the enterprise" (J.A. 275, *quoting Bennett*)—is broad enough to encompass the notion of "carrying out" or "carrying on." To "manage" includes the meaning, "[t]o conduct or carry on (a war, a business, an undertaking, an operation)." IX *Oxford English Dictionary* 292 (2d ed. 1989). To "operate" includes the meaning, "[t]o direct the working of; to manage, conduct, work (a railway, business, etc.); to carry out or through, direct to an end (a principle, an undertaking, etc.)." X *Oxford English Dictionary* 848 (2d ed. 1989). Thus, the Eighth Circuit's standard, applied literally, requires "some participation" in conducting, carrying on, carrying out, directing, managing or working "the affairs of the enterprise itself." The court below was faithful to the literal meaning of "conduct" as interpreted by petitioners and the Government; indeed, the dictionary definitions of these terms—"conduct," "operation," and "management"—are essentially interchangeable.

2. *The Statutory Structure.* In Section 1962(c), Congress established three prerequisites to liability: *first*, the defendant must be "employed by or associated with" an enterprise engaged in, or the activities of which affect, interstate or foreign commerce; *second*, the defendant must "conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs"; and *third*, that participation or conduct must be "through a pattern of racketeering activity or collection of unlawful debt." Contrary to the Government's contention (U.S. Br. 12), the Eighth Circuit's "operation or management" standard is fully compatible with this structure.

Under the court of appeals' standard, a defendant may operate or manage an enterprise "directly or indirectly"; there is nothing in the language of the decision that limits

liability to "insiders."<sup>15</sup> Further, the court below explicitly acknowledged that "management" and "operation" may be shared, giving full meaning to the "participation" language of the statute: the defendant need only have "'some participation in the operation or management of the enterprise itself.'" J.A. 275 (emphasis added; citation omitted). And equally important, the Eighth Circuit gave full meaning to the "conduct" element of Section 1962(c) by recognizing that mere participation in the affairs of a RICO enterprise is insufficient. *Bennett*, 710 F.2d at 1364 ("[m]ere participation in the predicate offenses listed in RICO, even in conjunction with a RICO enterprise, may be insufficient to support a RICO cause of action. A defendant's participation must be in the *conduct* of the affairs of a RICO enterprise") (emphasis added). As shown at pp. 25-29, *infra*, a fundamental flaw in the other standards advanced by petitioners' amici as definitive interpretations of Section 1962(c) is their failure to ascribe any meaning to the "conduct" requirement.

3. *Legislative History.* The "operation or management" test also finds support in RICO's legislative history. The Senate and House reports more than "merely track the statutory language" (U.S. Br. 13); rather, they describe Section 1962(c) as "proscribing the *operation* of any enterprise \* \* \* through a 'pattern' of 'racketeering activity.'" S. Rep. No. 617, 91st Cong., 1st Sess. 34 (1969) (emphasis added); H.R. Rep. No. 1549, 91st Cong., 2d Sess. 35 (1970). The Senate Report goes on to state that RICO "attacks \* \* \* corruption in the acquisition or *operation* of business." S. Rep. No. 617, *supra*, at 81 (emphasis added).<sup>16</sup> Moreover, the comments made

<sup>15</sup> See also *Yellow Bus*, 913 F.2d at 953 ("The 'operation and management' standard requirement can as easily be applied to—for example—an organized crime boss who pulls the strings of a corporation as it can to the corporation president himself.").

<sup>16</sup> The Government discounts this passage (Br. 14) by noting that it appears in the Senate Report's discussion of civil remedies and suggesting that its thrust is more pertinent to Section 1962(a),

during the course of floor debate concerning RICO indicate that "operate" (and "manage") are the concepts that Congress had in mind in enacting Section 1962(c). See U.S. Br. 14-15 n.13.

4. *RICO's Purpose.* The Eighth Circuit's "operation or management" standard is fully consistent with RICO's major purpose: eliminating "the infiltration of organized crime and racketeering into legitimate organizations operating in interstate commerce." S. Rep. No. 617, *supra*, at 76; *United States v. Turkette*, 452 U.S. 576, 591 & n.13 (1981). In Section 1962(c), Congress sought not to outlaw every predicate act committed in a business setting, but rather to forbid such acts only when they become the vehicle through which a defendant conducts, or participates in the conduct of, the enterprise's affairs. Importantly, however, the Eighth Circuit has construed the conduct element of Section 1962(c) broadly enough to encompass *all* members of an enterprise who participate in carrying out its affairs, even when those members are the "foot soldiers" and "smallest fish." See, e.g., *United States v. Kragness*, 830 F.2d 842, 857 (8th Cir. 1987) (affirming RICO convictions of low level distributors and transporter in illegal drug operation). The Eighth Circuit's standard thereby protects legitimate enterprises from unlawful infiltration at all levels. But when an outside entity's only connection with a legitimate enterprise is its performance for a limited period of time of strictly circumscribed, inherently external activities, such as an independent audit, the entity's connection with the enterprise is entirely too attenuated to raise a concern that the entity might infiltrate the enterprise.

This does not mean, of course, that accounting firms or other entities in the business of providing services

which prohibits a person from using or investing the proceeds of a pattern of racketeering activity "in acquisition of any interest in, or the establishment or operation of, any enterprise." 18 U.S.C. § 1962(a). However, there is nothing in the Report that indicates that its reach is so limited. The passage refers to "Title IX," and not merely Section 1962(a). S. Rep. No. 617, *supra*, at 81.

or goods to other businesses are exempt from RICO. Rather, consistently with Congress' predominant concern about the *operation* of enterprises through a pattern of racketeering activity, the entity can be subject to RICO's extraordinary sanctions only if it can be shown that the entity conducts its *own* affairs through a pattern of racketeering activity. As noted earlier (*see* n.12, *supra*), such an allegation was made in the proceedings below and rejected by the district court, which observed that to the extent Arthur Young's dealings with the Co-op were wrongful, they were aberrant and in no way typical of the firm. Under these circumstances, the particular concerns of Congress in creating RICO's severe remedies are not implicated and the remedies provided by the federal securities laws are fully adequate to address the predicate acts found by the jury in this case.

## II. OTHER "CONDUCT" TESTS PROPOSED BY PETITIONERS' AMICI WOULD IMPERMISSIBLY REWRITE THE STATUTE BY ELIMINATING THE CONDUCT REQUIREMENT ALTOGETHER

In a remarkable display of candor, petitioners straightforwardly assert that the conduct requirement "inherently cannot limit RICO in any relevant manner." Br. 20. Similarly, petitioners' amici advance several tests for the conduct requirement of Section 1962(c) that depart dramatically from the plain language of the statute and, in substance, would eliminate the conduct requirement entirely.<sup>17</sup> For that reason alone, the Court should reject them.

<sup>17</sup> These standards, with few exceptions, were neither formulated nor utilized by the courts to address the conduct requirement. Instead, they for the most part address a closely related but nonetheless analytically distinct issue under RICO, the "nexus" requirement—that is, the determination of whether, *given* a defendant's participation in the conduct of the enterprise's affairs, there exists a sufficient relationship between the defendant's racketeering activity and the enterprise to conclude, as the statute requires, that the defendant's participation in the conduct of the enterprise's affairs was *through* the pattern of racketeering activity. In each of the cases in which these nexus tests was articulated, the defendants had

1. *The Cauble Test.* Amicus National Association of Insurance Commissioners urges (NAIC Br. 14-16) the adoption of the "Seventh Circuit" test, which, it turns out, was first articulated by the Fifth Circuit in *United States v. Cauble*, 706 F.2d 1322 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984). In *Cauble*, the court required proof that: (1) the defendant committed the racketeering acts as alleged, (2) the defendant's position in the enterprise facilitated his commission of the racketeering acts, and (3) the predicate acts had some effect on the enterprise. 706 F.2d at 1333.

On its face *Cauble* does not include Section 1962(c)'s conduct requirement; nowhere in the test does the word "conduct"—or even any recognized synonym—appear. If *Cauble* were adopted as the test for "conduct," the effect would be to eliminate that statutory requirement altogether and to impose RICO liability for the mere commission of racketeering acts. That is because having established the predicate acts, a plaintiff would be required to show only (i) that the defendant's association with the enterprise "facilitated" the commission of those acts<sup>18</sup>

substantial day-to-day participation in the carrying out of the enterprise's affairs and therefore would have easily met the *Bennett* standard. See, e.g., *United States v. Scotto*, 641 F.2d 47, 51 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981); *United States v. Provenzano*, 688 F.2d 194, 196 (3d Cir.), *cert. denied*, 459 U.S. 1071 (1982); *United States v. Cauble*, 706 F.2d 1322, 1331, 1339-1341 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984); *United States v. Qaoud*, 777 F.2d 1105, 1107-1108, 1115 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986); *United States v. Pieper*, 854 F.2d 1020, 1023, 1026-1027 (7th Cir. 1988); *United States v. Yarbrough*, 852 F.2d 1522, 1526-1527 (9th Cir.), *cert. denied*, 488 U.S. 866 (1988).

Without analyzing their analytically distinct origins, petitioners' amici now propose the "nexus" standards set forth in these cases as tests for the "conduct" requirement. As we demonstrate above, using them in that fashion would extend RICO far beyond the purpose of Congress.

<sup>18</sup> In a recent decision, *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 533-534 (5th Cir. 1992) (emphasis added), the Fifth Circuit held that the second prong of the *Cauble* test is satisfied by proof

and (ii) that those acts had "some effect on the enterprise." As the Government observes (Br. 17 n.16), a RICO defendant's "association with an enterprise can be established through mere proof of a transaction with the enterprise." See, e.g., *United States v. Yonan*, 800 F.2d 164, 167 (7th Cir. 1986) ("[t]he cases make clear that the defendant need not have a stake in the enterprise's 'goals,' but can associate with the enterprise by conducting business with it"), *cert. denied*, 479 U.S. 1055 (1987). And proof that a defendant's association with the enterprise "facilitated" the commission of racketeering acts is a virtual given in every RICO case—one need only show that the transactions that establish the defendant's association with the enterprise are the very transactions that establish the predicate acts.

Thus, in the end, as the NAIC forthrightly acknowledges (Br. 15 n.15 (emphasis added)), the *Cauble* test is a mere "affects" test: "outsiders to the enterprise who affect its affairs may be reached under section 1962(c)." Under that standard any defendant who "affects" an enterprise through a pattern of racketeering activity—which means all defendants having transactions with the enterprise that constitute predicate acts—would be liable. But that result is utterly inconsistent with the congressional determination that RICO liability may be imposed not for the mere commission of racketeering acts, but only when such acts are the means through which the defendant conducts the affairs of the enterprise. There is simply no justification for the NAIC's attempt to rewrite the statutory language. See *H.J. Inc.*, 492 U.S. at 240-241 & n.3 (rejecting "multiple scheme" limitation on RICO's "pattern" requirement); *Sedima*, 473 U.S. at 495 (rejecting "racketeering injury" requirement); *Turkette*, 452 U.S. at 582-583, 585 (rejecting requirement that the RICO enterprise be a legitimate business).

that "the defendant's association with the enterprise facilitated the commission of the acts," thereby making it clear that a "position in" the enterprise is not required.

2. *The Scotto Test*. As the Government notes (Br. 17 n.17), *United States v. Scotto*, 641 F.2d 47 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981), is often cited as setting forth an appropriate "conduct" standard. In *Scotto*, the court asserted that "one conducts the activities of the enterprise through a pattern of racketeering activity when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of the enterprise." 641 F.2d at 54 (emphasis added). Nowhere in this disjunctive test does the word "conduct" appear. Rather, one is within Section 1962(c) under *Scotto* whenever the predicate offenses at issue are "related to" the activities of the enterprise. Like *Cauble*, *Scotto* is tantamount to a mere "affects" test capable of sweeping into the RICO net those who merely transact business with an enterprise at arm's length. The Government is correct (if somewhat restrained) in observing that *Scotto* "provides little concrete guidance and may suggest overbroad applications of RICO." U.S. Br. 17-18 n.17.

3. *The Bank of America Test*. Amicus National Association of Securities and Commercial Law Attorneys proposes the standard applied in *Bank of America Nat'l Trust & Savings Ass'n v. Touche Ross & Co.*, 782 F.2d 966 (11th Cir. 1986), as the definitive test of what "conduct" means. NASCAT Br. 30. In that case, the court ruled that "[t]he word 'conduct' in 1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise." 782 F.2d at 970. The Eleventh Circuit rejected an argument that Congress imposed a conduct requirement, and embraced the observation in *United States v. Watchmaker*, 761 F.2d 1459, 1476 (11th Cir. 1985), *cert. denied*, 474 U.S. 1100 (1986) (citation omitted), that:

The substantive prescriptions of the RICO statute apply to insiders and outsiders \* \* \* *who participate directly and indirectly in the enterprise's affairs through a pattern of racketeering activity.*

782 F.2d at 970 (emphasis altered). This test too ultimately rewrites the statute: it makes it a violation of RICO to "participate \* \* \* in the affairs of the enterprise" even though Congress chose to require more.

### III. INDEPENDENT AUDITORS DO NOT PARTICIPATE IN CARRYING OUT THE AFFAIRS OF THEIR AUDIT CLIENTS AND THEREFORE DO NOT SATISFY THE CONDUCT REQUIREMENT OF THE STATUTE WHEN ENGAGED IN AUDITING ACTIVITY

Despite the virtual impossibility of articulating any bright-line test for the "conduct" requirement of Section 1962(c) in every case (*see* pp. 45-49, *infra*), there exists a wide array of cases in which it is not difficult to determine that the requirement has been met. It is relatively easy, for example, to conclude that Section 1962(c) applies to defendants—whether "insiders" or "outsiders"—who engage in racketeering activity through the use of a wholly criminal enterprise. *See, e.g., United States v. Watchmaker*, 761 F.2d at 1475-1476 (defendants engaged in several acts of drug dealing and other crimes with other members of the enterprise, the affairs of which consisted, *inter alia*, of the sale of drugs). Similarly, there is little question that "insiders"—whether high-ranking or low-level employees—are within the statute's reach when their racketeering activity is intended to corrupt a legitimate enterprise, as in the case of the kick-back prosecutions cited by the Government. *See, e.g., United States v. Qaoud*, 777 F.2d 1105, 1107-1108, 1115-1117 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986).

The situations in which the statute presents the most difficult interpretative problems are those involving outsiders who act independently of a legitimate enterprise; the knotty issue in such cases is determining at what point the activities of those independent outsiders have become sufficiently connected to the enterprise that it is reasonable to treat the outsiders as participating in the conduct of the enterprise's affairs. One point, however, is clear: petitioners, respondent, and the Government agree

that, regardless of the test used to interpret the statute, the customary relationship between independent auditors and their clients does not implicate RICO. U.S. Br. 22; Pet. Br. 23-24, 27, 29. Although petitioners contend (Br. 23-24, 29) that Arthur Young's activities in this case went beyond those of an auditor, that fact-bound contention was correctly rejected by the courts below, as we demonstrate at pp. 38-43, *infra*. For present purposes, we focus on the reasons why the activities customarily undertaken by an independent public accountant, standing alone, do not satisfy the conduct requirement.

#### **A. Auditors Do Not Participate In The Conduct Of Their Clients' Affairs**

Generally accepted auditing standards provide a comprehensive framework that defines the activities performed by an outside accountant in the course of an audit. Most importantly, an independent public accounting firm in its auditing role simply expresses an opinion on the client's financial statements. See 1 [CCH] AICPA, *Professional Standards*, Statements on Auditing Standards ("SAS") No. 1, AU § 110.02. Independent audits are conducted for the specific purpose of issuing an opinion whether, in the auditor's professional judgment, an entity's financial position and results of operations have been fairly presented in all material respects in the financial statements issued by management.

An audit entails the following steps: First, the auditor establishes the scope of the audit, which requires the auditor to develop a reasonable sampling of transactions to be reviewed and to identify those areas in which there is the greatest likelihood of management error or misrepresentation. Second, having decided the initial scope of the audit, the auditor must then test the client's internal financial controls insofar as he plans to rely on those controls in the course of the audit. If those tests confirm the general reliability of the controls, the auditor may conclude that the extent of the substantive audit tests may be reduced. If, on the other hand, the tests

prove the controls unreliable, the auditor may have to expand the initial scope of the audit and build more substantive tests into the process. Third, the auditor conducts a thorough assessment of the evidential matter obtained during the sampling and testing phases; that assessment enables the auditor to express his ultimate opinion on the question whether the client's financial statements, taken as a whole, fairly present the company's financial position and results of operations in all material respects in accordance with GAAP.

An auditor does all of this at arm's length from the audit client. Public accountants are bound by the AICPA's Code of Professional Conduct to maintain their independence. 2 [CCH] AICPA, *Professional Standards*, Principles of Professional Conduct, Article IV, ET § 55. Rule 101 of the Code implements that principle by prohibiting an auditor from having "any direct or material indirect financial interest in the enterprise" audited (ET § 101.02 101-1.A.1) and from being connected with the enterprise "as a promoter, underwriter or voting trustee, or in any capacity equivalent to that of a member of management or of an employee." ET § 101.02 101-1.B.1. These prohibitions are also contained in the Securities and Exchange Commission's independence requirements for certified public accountants. See Regulation S-X, Rule 2-01 (b), 17 C.F.R. § 210.2-01.

Professional standards also clearly delineate the respective responsibilities of management and auditor with respect to the client's financial statements:

The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining an internal control structure that will, among other things, record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements \* \* \*. *The independent auditor may make suggestions about the*

*form or content of the financial statements, or draft them, in whole or part, based on information from management's accounting system.* However, the auditor's responsibility for the financial statements he has audited is confined to an expression of his opinion on them.

1 [CCH] AICPA, *Professional Standards*, SAS No. 1, § 110.02 (emphasis added). This principle—that the client and its management, not the auditor, bear the ultimate responsibility for the accuracy and adequacy of the client's financial statements—has long had the force of law. See, e.g., *In re Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939); Accounting Series Release (“ASR”) No. 62 (1947), Fed. Sec. L. Rep. (CCH) ¶ 72,081; ASR No. 126 (1972), Fed. Sec. L. Rep. (CCH) ¶ 72,148; R. Gormley, *The Law of Accountants and Auditors* 1-22 to 1-23 & nn.47-48.

In light of the foregoing, as both petitioners (Br. 23-24, 27) and the Government (Br. 22) concede, an independent auditor does not participate in the conduct of (or “carry out”) the affairs of the client. The client's management engages in transactions, buys and sells assets, and makes day-to-day business decisions in conducting its affairs; the independent auditor is precluded from doing so. The auditor may draft the client's financial statements based on the client's books and records, but the statements are ultimately those of the client's management. And the auditor, in the conduct of *its* affairs, tests the client's records and renders an opinion whether the client's financial statements fairly present the financial position and results of operations in accordance with GAAP.

If there were any doubt about the clear demarcation between an auditor and its client, Congress removed it in enacting the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”), Pub. L. No. 101-73, 103 Stat. 354. Under prior law, federal banking agencies had statutory authority to bring certain en-

forcement actions against an “insured institution” or a “director, officer, employee, agent or other person participating in the conduct of the [institution's] affairs.” 12 U.S.C. § 1730(e), (g) (repealed by Pub. L. No. 101-73, 103 Stat. 354). In enacting FIRREA, Congress deliberately “broaden[ed] the group of individuals and entities covered” by the agencies' enforcement authority. H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 439 (1989) (emphasis added). To effectuate this intent, Congress amended the relevant statutes to encompass accountants when they knowingly or recklessly engage in misconduct that causes significant harm to an insured institution, *but placed them in an entirely separate category from persons participating in the conduct of the affairs of an insured institution.* 12 U.S.C. § 1813(u) (4).<sup>19</sup>

In Congress' view, then, independent accountants do not, merely by engaging in auditing acts, participate in the conduct of their clients' affairs. It is a fundamental principle of statutory construction that “a court should ‘give effect, if possible, to every clause and word of a statute.’” *Moskal v. United States*, 111 S. Ct. 461, 466 (1990) (citation omitted). If independent contractors such as accountants were merely a subset of Section 1813(u) (3)—i.e., “person[s] \* \* \* who participate[] in the conduct

<sup>19</sup> Congress created a new statutory term to specify those who are subject to enforcement proceedings, “institution-affiliated party,” which it defined to include (12 U.S.C. § 1813(u) (emphasis added)):

(1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution;

(2) any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency under section 1817(j) of this title;

(3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate banking agency (by regulation or by case-by-case) *who participates in the conduct of the affairs of an insured depository institution; and*

(4) any independent contractor (including any attorney, appraiser, or accountant) \* \* \*.

of the affairs" of an insured institution—Section 1813 (u)(4) would be superfluous. Congress' clear understanding that accountants performing only auditing activity were not covered by that unique phraseology in the banking laws thus sheds considerable light on the meaning of the virtually identical phrase as used in RICO.

In sum, the controlling professional standards and legal principles establish that independent public accountants do not participate in the conduct of their clients' affairs merely by engaging in auditing activity.

**B. The Policy Underlying RICO Demonstrates That The "Conduct" Element Of Section 1962(c) Is Not Satisfied By Auditing Activity**

Given the limited nature of an auditor's function, one cannot justify the imposition of Section 1962(c) liability on the ground that an auditor has participated in the conduct of the client's affairs merely by engaging in auditing activity. In enacting RICO, Congress attempted to stem the infiltration of organized crime and racketeering into legitimate organizations. See p. 24, *supra*.<sup>20</sup> By definition, an independent auditor, merely by

<sup>20</sup> The NAIC's claim that RICO was intended to "snare accounting firms" (Br. 16 n.16) is highly misleading. In fact, two of the three floor debates on which the NAIC relies demonstrate exactly the opposite—i.e., that Congress was concerned that organized crime was infiltrating the accounting profession itself. See 113 Cong. Rec. 17949 (1967) ("According to the [National Crime] Commission, organized crime has moved into businesses ranging from accounting to yeast manufacturing."); 116 Cong. Rec. 592 (1970) (listing accounting as one of many businesses and industries in which organized crime has been active). Thus, the NAIC has the infiltrators and those being infiltrated mixed up. The third passage cited by the NAIC is no more convincing; it says: "Indeed, to protect themselves from suit and prosecution, various criminal cartels employ staffs of attorneys, accountants, and business consultants—many of whom do nothing more than work exclusively on the quasi-legitimate business affairs of organized crime." 113 Cong. Rec. 17950 (1967). That activity is far removed from the typical services provided by an independent auditor.

engaging in auditing activity, does not corrupt or usurp the functions of the audit client. What an auditor does—and the most that an auditor is permitted to do and still be considered independent—is test the transactions of the client as reflected in the client's books and records and render a professional opinion. Stated differently, an auditor's conduct of its own affairs through the provision of professional services to a client cannot, as a matter of common sense, be seen as posing any threat of "infiltration" of the client's affairs.

An auditor's role in relation to its client stands in marked contrast to the activities of the defendants in cases exemplifying what the Government identifies (Br. 19) as "characteristic applications" of RICO. Thus, in the first category, where "the defendant's racketeering activity directly furthers the objectives of the enterprise" (*id.*), the facts of the cases relied on demonstrate that the defendants had substantial, day-to-day participation in carrying out the business of the enterprises alleged.<sup>21</sup> An auditor could conduct none of these activities in relation to its client and remain an independent auditor.

The second and third categories of typical RICO cases identified by the Government (Br. 19-21) are, in fact,

<sup>21</sup> See *United States v. Watchmaker*, 761 F.2d at 1463, 1475-1476 (defendants engaged in several acts of drug dealing and other crimes with other members of the enterprise, the affairs of which consisted, *inter alia*, of the sale of drugs); *United States v. Ellison*, 793 F.2d 942, 945, 950 (8th Cir.) (defendant was founder and leader of white supremacy group and his position enabled him "to assign members to specific jobs and tasks and to direct their activities, both legitimate and illegitimate"), *cert. denied*, 479 U.S. 937 (1986); *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987) (employee of subsidiary participated in the conduct of the parent company by fraudulently procuring contracts for the subsidiary, where a portion of the parent's business was through that subsidiary and the employee was the manager of the subsidiary and acting on the parent's behalf); *United States v. Zauber*, 857 F.2d 137, 140, 150 & n.16 (3d Cir. 1988) (pension fund officials participated in the conduct of a mortgage company by providing it with its only source of capital), *cert. denied*, 489 U.S. 1006 (1989).

but one category—cases in which the defendant corrupts an otherwise legitimate enterprise through a pattern of racketeering acts. The only discernible difference between categories “b” and “c” is that “insiders” fall within the former and “outsiders” within the latter.<sup>22</sup> In each case, the defendant, whether insider or outsider, substantially participated in the day-to-day affairs of the enterprise.<sup>23</sup> Indeed, in the bribery cases cited by the Government, the defendant more than participates in the conduct of the enterprise’s affairs; through his payments, the defendant seeks to control them.

The activities of the defendants in the Government’s category “b” and “c” cases stand worlds apart from what an auditor typically does or is capable of doing. While independent auditors may commit predicate acts during the course of their circumscribed activities, they do not infiltrate the client’s business and turn it to illegal ends. Stated simply, auditors are engaged in the conduct of their *own* affairs; that their work may be “necessary or helpful” to or may in some fashion “relate to” or have “some effect” on the affairs of the client enterprise does not mean that the auditor is participating in carrying out its *client’s* affairs.

In the end, the Government apparently does not believe that auditor-defendants fall into any of the three categories that it has created. U.S. Br 19. Instead, it concludes with a catch-all category that is singularly unhelpful: according to the Government, in category “d” cases, “the ultimate inquiry is whether the defendant has carried out the affairs of the enterprise through a pattern of predicate

<sup>22</sup> Compare, e.g., *United States v. Qaoud*, 777 F.2d at 1107-1108 (acceptance of bribes by judge), with, e.g., *United States v. Roth*, 860 F.2d 1382, 1383 (7th Cir. 1988) (payment of bribes by lawyer to judge), *cert. denied*, 490 U.S. 1080 (1989).

<sup>23</sup> See, e.g., *United States v. LeRoy*, 687 F.2d 610, 617 (2d Cir. 1982) (defendant used his position as vice president and later business manager of union local to obtain illegal payments and embezzle funds), *cert. denied*, 459 U.S. 1174 (1983); *United States v. Roth*, *supra*, n.22.

crimes.” U.S. Br. 21. Having reduced its analysis to a mere restatement of the statutory language, the Government’s position then seems to be nothing more than a thinly-disguised attempt to persuade the Court that auditors may be liable for RICO violations simply by virtue of having committed predicate acts. The Government tells us that, if a outside auditor maintains the professionally-mandated degree of independence from its client, RICO will not be implicated. U.S. Br. 22. If the auditor in some ill-defined way compromises its independence, however, then “it may fairly be characterized as a participant in the conduct of the organization’s affairs.” *Ibid.* (footnote omitted). In other words, the Government tells us that an auditor that does its job properly need not worry about RICO liability, but an auditor that missteps may find itself liable not only for the predicate acts but for a RICO violation as well.<sup>24</sup>

In our submission, if an auditor engaged to render traditional professional services for its client has committed the necessary predicate acts (such as the jury found to be the case with Arthur Young’s audits of the Co-op’s financial statements) it may fairly be held accountable for those predicate acts, but no more. See *Sedima*, 473 U.S. at 496 (“mere commission of the predicate offenses” is not in itself a violation of Section 1962(c)). Whatever test might be adopted to elucidate the conduct requirement cannot transform the rendition of professional services to an enterprise—even when those services turn out to have been performed in violation of the securities laws—into RICO violations. Indeed, if “conduct” were really as amorphous as the Government

<sup>24</sup> The Government gives passing nod to the notion that “[i]solated or sporadic misconduct in the course of a client engagement” might not trigger RICO’s application. U.S. Br. 22 n.24. According to the Government, however, this is so only because RICO’s pattern requirement will not likely have been satisfied in such situations. *Ibid.* While that is undoubtedly correct and is in fact the case here (see pp. 43-45, *infra*), it provides no additional guidance on the interpretation of the conduct requirement.

suggests, it surely would run afoul of the Due Process Clause of the Fifth Amendment. *See* pp. 45-49, *infra*.

#### IV. ARTHUR YOUNG ENGAGED IN NOTHING MORE THAN TRADITIONAL AUDITING ACTIVITY

Petitioners' ultimate contention in this case is that Arthur Young participated in the conduct of the Co-op's demand note program through a pattern of securities fraud. Br. 21-22, 42-43. That contention rests exclusively on Arthur Young's audits of the Co-op's 1981 and 1982 financial statements, for as the district court concluded, there was no evidence to support the claim that Arthur Young played an active role in the purchase or sale of the Co-op's demand notes (*see* p. 3, *supra*), a ruling that petitioners did not appeal. Inasmuch as petitioners themselves concede that the conduct requirement of Section 1962(c) is not satisfied by auditing activity standing alone, the controlling issue here is whether Arthur Young's activity extended beyond auditing.

On a fully developed summary judgment record, and viewing the evidence in the light most favorable to petitioners, the district court (J.A. 7, 199-200) and the court of appeals (*id.* at 274-275) came to the same conclusion—that "Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings." *Id.* at 275.

The district court set forth the precise activities of Arthur Young that petitioners contended went beyond normal auditing (J.A. 199):

(a) the accountants allegedly created the Co-op's financial statements; (b) the accountants failed to obtain client representation letters; (c) they addressed shareholder meetings; (d) they participated in the creation of condensed financial statements; and (e) the accountants helped the Co-op handle certain matters with government agencies.

None of these activities constitutes a basis for setting aside the conclusion of the courts below that Arthur Young engaged in auditing and nothing more.

A. "Creating the Co-op's Financial Statements." In opposing summary judgment, petitioners argued to the district court that Arthur Young acted as the Co-op's internal accountant by drafting the Co-op's financial statements and by making substantive decisions concerning the accounting method used for the gasohol plant.<sup>25</sup> As noted above (*see* pp. 31-32, *supra*), drafting or assisting in the drafting of the client's financial statements is a core auditing function. Moreover, the summary judgment record contains un rebutted evidence (some of it from petitioners' accounting expert) that establishes beyond a doubt that Arthur Young utilized existing Co-op records in conducting the audits (Reply Mem. Exhibits, Vol. I at 12), and that that is precisely what auditors do.

The contention that the Co-op's management and board of directors were duped on the plant's carrying value—and that the carrying value decision was therefore reached by Arthur Young alone—stands on no firmer ground. Footnote 9 to the Co-op's 1981 financial statements states explicitly that the Co-op acquired legal ownership of the plant in February 1980, but that the carrying value of the plant was nonetheless determined on the basis of the financing provided by the Co-op for the initial construction and revision of the plant. C.A. Jt. App. 250-251. Accordingly, while the board may not have been told in detail about the specific accounting principle used to report the cost of the gasohol plant, it knew the basis of the valuation decision and when the Co-op acquired legal title to the plant. Further, the reference in Arthur Young's audit opinion to footnote 9 to the 1981 financial statements makes it clear that Arthur Young had serious doubts about the recoverability of the Co-op's investment

<sup>25</sup> Plaintiffs' Responding Memorandum to the Motion of the Arthur Young Defendants for Summary Judgment, Nos. 85-2044, 2096, 2155 & 2259 (W.D. Ark. filed September 4, 1986) ("Plaintiff's Summary Judgment Mem."), at 56-62.

in the plant and needed projections and other analyses from management to address that issue. C.A. Jt. App. 235, 250-252. Thus, there is nothing in the summary judgment record to support petitioners' assertion that Arthur Young functioned as the Co-op's internal accountant.

*B. The Management Representation Letters.* Petitioners also argued to the district court that Arthur Young's failure to secure representation letters from the Co-op's management had the effect of making Arthur Young and not the Co-op's management ultimately responsible for the Co-op's financial statements. Plaintiff's Summary Judgment Mem. 63. That is plainly not the case. As explained earlier (*see* n.10, *supra*), Arthur Young mistakenly thought that it had a signed management representation letter for the 1981 audit, and it did not interpret Kirit Goradia's failure to sign the 1982 letter as a refusal by management to take responsibility for the Co-op's financial statements because Fred Howard, the Co-op's general manager, did sign the 1982 letter.

At *worst*, these facts might show noncompliance by Arthur Young with applicable professional standards.<sup>26</sup> Even that is questionable, however, because petitioners do not contend that management *refused* to sign a representation letter in 1981; the record merely shows that Arthur Young mistakenly believed that it had such a

<sup>26</sup> Professional standards require an auditor to obtain written representations from management concerning evidential matter that the auditor obtains during the course of the audit. 1 [CCH] AICPA, *Professional Standards*, AU §§ 333.01-333.03. The standards further provide that the written representations "should be signed by members of management whom the auditor believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered by the representations. Normally, the chief executive officer and the chief financial officer should sign the representations." *Id.* at AU § 333.09. Finally, the standards provide that "[m]anagement's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. Further, the auditor should consider the effect of a refusal on his ability to rely on other management representations." *Id.* at AU § 333.11.

letter in its files. As for 1982, "management" did not refuse to sign; instead, Arthur Young concluded that Fred Howard alone was a sufficient representative of management. Assuming *arguendo* that Arthur Young should have treated Goradia's failure to sign the 1982 letter as a refusal to sign by "management," petitioners have done no more than (re)establish part of their case on the predicate acts of securities fraud. They have not to this day explained how the absence of the signed letters transformed Arthur Young into the *de facto* management of the Co-op. The mere commission of predicate acts, without proof of the "conduct" requirement, does not establish a RICO claim. *See Sedima*, 473 U.S. at 496.

*C. The Co-op's Annual Meetings.* It is commonplace for auditors to speak at shareholder meetings, and the proxy rules of the SEC explicitly acknowledge that role. Thus, 17 C.F.R. § 240.14a-101, Item 9(c) provides that:

The proxy statement shall indicate (1) whether or not representatives of the principal accountant for the current year and for the most recently completed fiscal year are expected to be present at the security holders' meeting, (2) whether or not they will have the opportunity to make a statement if they desire to do so and (3) whether or not such representatives are expected to be available to respond to appropriate questions.

Thus, the courts below correctly concluded that Arthur Young did not depart from its role as an auditor in addressing the Co-op members at two annual meetings.

*D. The Condensed Financial Statements.* The condensed financial statements disseminated at the annual meetings were prepared by Kirit Goradia and not Arthur Young, and were based on the audited financial statements drafted by Arthur Young. J.A. 249 n.9. With respect to the 1981 condensed financial statements, the most that petitioners contend is that they were sent to Arthur Young and returned unchanged. Br. 16.<sup>27</sup> As for the

<sup>27</sup> Petitioners also contend (Br. 16) that Arthur Young knew *at that time* that the condensed statements were misleading. As we

1982 condensed statements, Arthur Young informed Goradia that its name should not appear on them because the statements were misleading. J.A. 257. At both the 1982 and 1983 meetings, Arthur Young informed the members that they had been given only condensed financial statements and that the complete audited financial statements were available at the Co-op's offices. J.A. 250, 258. In the end, the contention that Arthur Young participated in the creation of condensed financial statements adds nothing, since those statements were based on (though considerably less accurate than) the complete audited financial statements drafted by Arthur Young.

*E. Government Inquiry.* The final act of "conduct" considered by the district court was a letter from Arthur Young responding to an inquiry from the United States Department of Agriculture. Pet. Br. 17-18. Although petitioners do not argue that this letter constituted "conduct," the district court considered it (J.A. 199) and concluded that it was not. An examination of the particular communication relied on by petitioners (C.A. Jt. App. 1261-1262), which they blatantly misstate (see Reply Mem. Exhibits, Vol. 1 at 10), demonstrates that the district court was correct. That document is a letter dated September 9, 1983, in which Arthur Young, in response to a request from the Department of Agriculture for financial information concerning the Co-op, stated that professional standards prohibited Arthur Young from preparing a review report concerning the Co-op's financial statements because Arthur Young had been required to qualify its audit opinions in light of management's failure to provide the projections and analyses needed to assess the recoverability of the investment in the gasohol plant. Quite clearly, Arthur Young's refusal to comply with the USDA request is the very antithesis of participation in the conduct of the Co-op's affairs.

For all of these reasons, the courts below were correct in concluding that Arthur Young engaged in auditing

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have explained earlier (see n.11, *supra*), petitioners have misstated the chronology of events.

activity but nothing more. Petitioners' response is to urge that the case be remanded with directions that their RICO claim be analyzed under the "traditional and accepted" meanings of the words used in the statute itself. Br. 41-43. But implicit in that argument, at least in this case, is the notion that *every* RICO claim should be submitted to the jury for consideration in light of these "traditional and accepted" statutory words, which is to say that the courts have no screening function in RICO cases and that every RICO claim against an outside auditor is sufficient as a matter of law whatever the record may reveal. We submit that that is wrongheaded, and that the courts below correctly concluded that auditing activity, standing alone, does not equal "conduct" and that in *this* particular case Arthur Young engaged in audits of the Co-op's financial statements, but nothing more.

#### V. ARTHUR YOUNG'S AUDITING ACTIVITY DOES NOT SATISFY RICO'S PATTERN REQUIREMENT

In its motion for summary judgment, respondent argued that petitioners' RICO claim was defective because it did not satisfy the pattern requirement of Section 1962(c). Neither the district court nor the court of appeals reached that issue because both concluded that Arthur Young did not participate in the conduct of the Co-op's affairs. J.A. 198-200, 273-277. Although it is not the question presented by petitioners in this case, petitioners' inability to satisfy the pattern requirement provides an alternative ground for affirmance.

*H.J. Inc.* establishes that *in addition* to the two predicate acts required by the statute, petitioners "must show that the racketeering predicates are related, and that they amount to or pose a threat of continued criminal activity." 492 U.S. at 239. Adopting a "common-sense" approach, the Court ruled that a plaintiff can satisfy the "continuity" requirement by showing either a "closed period of repeated conduct, or \* \* \* past conduct that by its nature projects into the future with a threat of repetition." *Id.* at 241.

Here, petitioners can prove neither the presence nor the threat of continued criminal activity that RICO was adopted to attack. Where there is no threat of further racketeering, *H.J. Inc.* teaches that "acts extending over a few weeks or months" are not enough. 492 U.S. at 242. That precisely describes Arthur Young's relationship with the Co-op and the nature of the predicate acts at issue in this case. Arthur Young's involvement with the Co-op was sporadic—or, as one court describing an audit relationship stated, "occasional"—consisting of an audit conducted over a period of a few months in early 1982 and again in early 1983. See *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980). And it bears emphasis that however petitioners may try to dress up their argument, they cannot avoid the fact that their RICO claim essentially relates to one accounting decision concerning one asset of one company: their contention is that, in its first year of auditing the Co-op's financial statements, Arthur Young fraudulently overstated the carrying value of the gasohol plant and drafted false financial statements based on that overstatement and then repeated this same mistake in the next year. "Common sense" dictates that the same act of securities fraud committed in one year and repeated again the following year cannot constitute "a closed period of repeated conduct" (492 U.S. at 241) or "continued criminal activity" (*id.* at 239) within the meaning of RICO. Cf. *Blake v. Dierdorff*, 856 F.2d 1365, 1371 (9th Cir. 1988) (holding that alleged frauds arising out of a single independent audit do not constitute a pattern of racketeering activity).<sup>28</sup> Arthur Young's activity thus stands in dramatic contrast to the allegations held to be sufficient in *H.J. Inc.*: "that at different times over the course of at least a 6-year period the noncommissioner respondents gave five

<sup>28</sup> Indeed, the present case is, for all practical purposes, a single audit case even though Arthur Young served as the Co-op's auditor for two years. Having decided in year one that the appropriate accounting treatment under GAAP was to report the carrying value of the gasohol plant at historical cost, Arthur Young would have had no occasion to revisit that decision in year two.

members of the MPUC numerous bribes, in several different forms, with the objective—in which they were allegedly successful—of causing these commissioners to approve unfair and unreasonable rates for Northwestern Bell." 492 U.S. at 250.

Nor did Arthur Young's activity pose a threat of continued criminal activity. It is undisputed that Arthur Young's relationship with the Co-op ended in the fall of 1983 after Arthur Young indicated that it might render an adverse or disclaimed opinion on the Co-op's 1983 financial statements unless the Co-op took certain steps with respect to the gasohol plant. See Tr. Vol. X at 149-151. The Co-op then retained another accounting firm to audit its 1983 financial statements. Accordingly, there could not be, under any circumstances, a threat of continued criminal activity on the facts of this case.

**VI. IF SECTION 1962(c) IS CONSTRUED AS ENCOMPASSING MERE AUDITING ACTIVITY IN SOME CIRCUMSTANCES BUT NOT IN OTHERS, THE STATUTE IS IMPERMISSIBLY VAGUE AND VIOLATES THE DUE PROCESS CLAUSE OF THE FIFTH AMENDMENT**

Our principal submission is that the conduct requirement of Section 1962(c) cannot reasonably be construed as encompassing the typical professional services provided to a client by an independent auditor. If the Court should conclude that mere auditing activity *can*, under some circumstances, satisfy the conduct requirement, then we submit that it is impossible to find any interpretation of Section 1962(c) that both (1) gives the conduct requirement some meaning, and (2) provides reasonably clear guidance to the public, prosecutors, courts, and juries on the demarcation between auditing activity that does not constitute participation in the conduct of the affairs of a client. In these circumstances, Section 1962(c) must be declared unconstitutionally vague.<sup>29</sup>

<sup>29</sup> We also submit that Section 1962(c) is unconstitutional because of the vagueness of its "pattern" requirement, as amply demon-

"[A] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926). Because RICO is both a criminal and civil statute, the standard of certainty and specificity for the conduct requirement is high. See *FCC v. American Broadcasting Co.*, 347 U.S. 284, 296 (1954) ("It is true \* \* \* that these are not criminal cases, but it is a criminal statute that we must interpret. There cannot be one construction for the [FCC] and another for the Department of Justice.").

The Court has articulated two primary reasons why vague laws impinge upon fundamental protections provided by the Due Process Clause:

First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning. Second, if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them. A vague law impermissibly delegates basic policy matters to policemen, judges, and juries for resolution on an *ad hoc* and subjective basis, with the attendant dangers of arbitrary and discriminatory applications.

*Village of Hoffman Estates v. Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 498 (1982) (citation omitted). Accord *Smith v. Goguen*, 415 U.S. 566, 572-573 (1974) (vagueness doctrine "requires legislatures to set reasonably clear guidelines for law enforcement officials and triers of fact in order to prevent 'arbitrary and discriminatory enforcement'") (footnote omitted); *United States v. Reese*, 92 U.S. 214, 221 (1876) ("It would certainly be

strated by Justice Scalia's concurrence in *H.J. Inc.*, 492 U.S. at 254-256, in language that we cannot improve upon.

dangerous if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large.").

When considered in the context of RICO, the Court's articulations of the dangers of an impermissively vague statute certainly strike a responsive chord. As has been noted often, Congress intended to use "terms of breadth" in RICO and for these terms to be "liberally construed" to effectuate RICO's purposes. The Constitution, however, does not allow a legislature unfettered freedom to paint with such a broad brush. By casting a net conceivably large enough to catch all possible offenders through its use of imprecise language, Congress may well have impermissively delegated basic policy matters to law enforcement officials and triers of fact for resolution on an "*ad hoc* and subjective basis." In the absence of any reasonable guidelines to provide content to the statutory language, RICO cannot survive under due process of law.

The indefiniteness of RICO's conduct requirement is graphically demonstrated by the veritable kaleidoscope of tests that have been devised by the courts of appeals in their struggle to ascribe some concrete meaning to the statutory language. See *Yellow Bus*, 913 F.2d at 952-954 (canvassing court of appeals cases addressing the conduct requirement). Moreover, when these tests are interpreted as broad enough to encompass, under some circumstances, the typical relationship between client and outside accountant, the invariable result has been that the scope of RICO's conduct requirement is left to the "*ad hoc* and subjective" determinations of finders of fact.<sup>30</sup> Despite widely varying levels of accountant in-

<sup>30</sup> In contrast, courts that have interpreted the conduct test as raising only the question whether the outside accountant's involvement with its client exceeded the typical professional relationship have been able to decide cases as a matter of law. See, e.g., *Reves*, J.A. 275; *Morin v. Trupin*, 747 F. Supp. 1051, 1066 (S.D.N.Y. 1990); *Goldman v. McMahon, Brafman, Morgan & Co.*, 706 F. Supp. 256, 261-262 (S.D.N.Y. 1989); *Plains/Anadarko-P Ltd. Partnership v. Coopers & Lybrand*, 658 F. Supp. 238, 240 (S.D.N.Y. 1987).

volvement in the client's affairs, courts have ruled that all of these cases should go to the jury because there is no ascertainable standard to distinguish between those cases in which the accountant participates in the conduct of the client's affairs from those in which it does not. See, e.g., *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 534 (5th Cir. 1992) (reversal of summary judgment in favor of auditor because allegations of auditing activity entitled plaintiffs "to take their RICO case to a jury"); *Bank of America*, 782 F.2d at 970 (whether independent auditors meet conduct requirement is "question of fact that may not be addressed on a motion to dismiss"); *Schacht v. Brown*, 711 F.2d 1343, 1345, 1353 (7th Cir.) (accounting firms who audited enterprise and failed to disclose its insolvency "at least arguably" fell within conduct requirement), *cert. denied*, 464 U.S. 1002 (1983); *Gilmore v. Berg*, 761 F. Supp. 358, 363, 375 (D.N.J. 1991) (accountant's preparation of forecast letter, which merely involved one meeting with the client's principal, several hours performing computations, and compensation of \$3,000, was "sufficient evidence to let the jury decide" whether the conduct requirement was met); *Baggio v. EC Solar, Inc.*, No. 88 C 1893, 1990 U.S. Dist. LEXIS 5569, at \*3-\*4, \*27-\*28 (N.D. Ill. May 8, 1990) (preparation and mailing of partnership tax returns precluded granting of motion to dismiss); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1494 (D. Or. 1985) (assistance in SEC registration, preparation of financial statements and quarterly aging reports, and single speech at annual meeting sufficient to raise issue of fact as to whether independent auditor was "substantially connected" to client).

The inherent unfairness and arbitrariness of this state of affairs is not likely to improve under any of the interpretations of the conduct requirement that have been offered by petitioners and their amici. For example, petitioners ask the Court to adopt a regime under which the specific facts of each case are simply plugged into the statutory language and juries are left to decide on

a case-by-case basis whether the accountant has "conducted" its client's affairs. Br. 21-22, 42-43. Alternatively, petitioners and their amici offer interpretations that would read the conduct requirement right out of the statute. See pp. 25-29, *supra*. All outside accountants, as well as most other outside providers of goods and services to legitimate enterprises, would be subject to RICO liability. While dropping the conduct requirement certainly eliminates its vagueness, Congress clearly intended the conduct requirement to have *some* meaning.

In sum, Congress provided only two guideposts for interpreting the conduct requirement of Section 1962(c). First, it intended for "conduct" to have some meaning and therefore did not intend for persons who merely "participate in" a legitimate company's affairs, even through a pattern of racketeering activity, to fall within RICO's net. Second, Congress intended for some outsiders to be covered by RICO, but provided little or no guidance as to which ones. If the Court should decide that the statute can encompass the typical relationship between a legitimate enterprise and its outside auditor, then the accounting profession will be left adrift in a sea of ambiguity where the statute may or may not cover any particular accountant and there is no prospect of any reasonable limits on the *ad hoc* and subjective determinations of prosecutors, plaintiffs' lawyers, judges, and juries. This state of affairs cannot be tolerated under the constitutional guarantee of due process of law.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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## APPENDIX

18 U.S.C. § 1962 provides:

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participation in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern o[f] racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

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(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b), or (c) of this section.

JUL 16 1992

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No. 91-886

In The  
Supreme Court of the United States  
October Term, 1992

BOB REVES, ROBERT H. GIBBS, and  
FRANCES GRAHAM, As Representatives  
Of A Class Of Note Holders,

*Petitioners,*

v.

ERNST & YOUNG,

*Respondent.*

On Writ Of Certiorari  
To The United States Court Of Appeals  
For The Eighth Circuit

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## REPLY OF PETITIONERS

We reply to three arguments raised by the briefs of Arthur Young and its amici: (I) legally, whether RICO should be read to exempt auditors (or any other class of outsiders); (II) factually, whether Arthur Young did nothing more than engage in "traditional auditing activities"; and (III) whether Arthur Young can now advance two issues not set forth in any petition for certiorari and not decided by either court below.

### I. SECTION 1962(C) DOES NOT EXEMPT AUDITORS (OR ANY OTHER CLASS OF OUTSIDERS) FROM RICO LIABILITY.

#### A. Arthur Young's Request For An Auditors' Exemption

Arthur Young pays lip service to the Eighth Circuit's "management or operation" test but makes no effort to apply the test to this case or to any other set of facts. Arthur Young fails to do so because, as we pointed out already, the Eighth Circuit's test will not catch the outside attorney who bribes the prosecutor's office<sup>1</sup> or the "smallest fish" and "foot soldiers" that Arthur Young concedes should be netted by 18 U.S.C. § 1962(c). (AY Br. 24.) Arthur Young therefore asks the Court to fashion a rule solely for auditors, arguing that "outside accountants who limit their involvement with a client to traditional auditing activities" should be *exempt* from RICO liability. (AY Br. 18.) Amicus AICPA supports Arthur

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<sup>1</sup> *United States v. Yonan*, 800 F.2d 164 (7th Cir. 1986), *cert. denied*, 479 U.S. 1055 (1987).

Young's request for an auditors' exemption, while amicus AFL-CIO seeks an exemption for unions.

The proposed exemptions, like the Eighth Circuit's test, are at odds with the plain words and purpose of section 1962(c) and should not be granted. The impropriety of the proposed exemption (and the Eighth Circuit's test) is highlighted by recalling Arthur Young's conduct here: the jury, the district court and the Eighth Circuit all agreed that Arthur Young, *using its position as the auditor for the Co-Op and acting alone*, originated a multimillion dollar securities fraud and maintained it for nearly three years, causing tremendous damage to thousands of innocent persons. Moreover, neither Arthur Young nor its amici explain why the same reasoning would not give exemptions to every class of "outsiders," including lawyers fraudulently doing "traditional" legal work and appraisers fraudulently preparing "traditional" valuations.

Additional evidence that the proposed auditors' exemption would be improper is provided by the contradictory arguments made by Arthur Young and its amici. AICPA and AFL-CIO base their exemption arguments exclusively on the statutory noun "conduct," which they believe means "control." For example, AICPA argues that, in *Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948 (D.C. Cir. 1990) (en banc), cert. denied, 111 S. Ct. 2839 (1991) ("*Yellow Bus*"), the D.C. Circuit "adopted in substantially identical form the standard announced in *Bennett*." The AICPA then approvingly states that the *Yellow Bus* holding requires a plaintiff to prove that the defendant "exercised significant control over or within an enterprise. . . ." (AICPA Br. 19

(emphasis added).) Similarly, the district judge in this case believed that the "management or operation" test set forth in *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008 (1983) required us to prove that Arthur Young controlled the Co-Op. He concluded that Arthur Young did not and entered summary judgment against us. (JA 198-200.)

Arthur Young parts company with the district judge, the D.C. Circuit, and its own amici on the "conduct means control" issue. It urges that *Yellow Bus*, with its focus on "control," misapprehends both *Bennett* and RICO. Indeed, Arthur Young agrees with us that applying the veneer of "control" to the noun "conduct" is plainly wrong, given the dictionary definitions of "conduct" and the congressional admonition to construe RICO liberally. Arthur Young also claims that our discussion of the "control" issue was a "red herring" and accuses us of unfairly pretending that such arguments are even at issue. (AY Br. 19-22.)

Still at odds with its amici, Arthur Young then denigrates the importance of dictionary definitions of "conduct" (which it concedes support us). Arthur Young "doubts their utility in this case" and "see[s] little purpose" in "engaging [us] in a 'battle of the dictionaries.'" (AY Br. 21-23, esp. n.14.) Moreover, Arthur Young agrees with us that section 1962(c) liability extends to those who merely "share" in the "conduct" of "affairs" (AY Br. 23), to "foot soldiers" and the "smallest fish" (AY Br. 24), and to those who are not enterprise "insiders" (AY Br. 23, 49). Indeed, Arthur Young generally concedes that "Congress intended to use 'terms of breadth' in RICO and for those terms to be 'liberally construed. . . ." (AY Br. 47.)

**B. Section 1962(c) Cannot Be Interpreted To Provide An Exemption For Auditors.**

Having conceded the points identified in A, above (as well as other points that we discuss later), Arthur Young tries to recover by placing all of its forensic eggs in one basket – the legislative history of RICO. But Arthur Young loses this fight on two grounds. First, Arthur Young cannot even use the legislative history because the statutory language covering the “participation” element of section 1962(c) has a plain meaning that is unambiguous, and there is no clearly expressed legislative intent to the contrary. Accordingly, the statutory language is conclusive. *Russello v. United States*, 464 U.S. 16, 20 (1983), citing *United States v. Turkette*, 452 U.S. 576, 580 (1981), quoting from *Consumer Product Safety Comm’n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). Second, the legislative history does not support Arthur Young’s argument that auditors are exempt from RICO liability. In fact, as Arthur Young concedes, Congress expressly recognized that accountants and auditors *could* be reached under RICO. (AY Br. 34 n.20.)

In reviewing the arguments made and opinions cited by all briefwriters on the issue of statutory interpretation, we note that the Court has approved as many as six guides on the subject, four primary because they look to the language of the statute (A-D, below) and two secondary because they may come into play (if at all) only if the statutory language is ambiguous (E-F, below). We now try to answer everyone’s arguments through an attempted restatement and application of the Court’s prior teachings on statutory interpretation. In doing so, we discuss both

general reasons for (and limitations on) the use of each guide and its specific application to the proposed auditor exemption.

(A) *Dictionary definitions* were known to the members of Congress, staff, lobbyists, and other technical experts who helped choose RICO’s language, and to the President who signed the bill into law. They have the further advantage of accessibility to all citizens, who after all should be able to understand their country’s statutes as citizens, as jurors, and as voters who evaluate the officials enacting the statutes. Dictionary definitions should converge with prior judicial interpretations (see B, below) since dictionaries (especially law dictionaries) are supposed to reflect usage (including judicial usage) and judges generally do (and should) use words in accord with their dictionary meanings.

(B) *Prior judicial interpretations* of statutory words also were accessible to statute-makers, who would have had every reason to expect courts to continue to interpret the same words in the same way and therefore presumably intended that to happen. Continuing the interpretations not only therefore respects original legislative intent, but also aids lawyers and judges trying to interpret the new law. If the contrary occurs, *i.e.*, if the same word is given a different meaning in a similar statute, confusion can result, especially when both statutes are involved in the same matter (*e.g.*, instructing a jury). Without good reason, courts should not impute to statute-makers the intent to create such anomalies.

In this case, Arthur Young (and its amici) nowhere dispute our arguments that the dictionary definitions and

judicial interpretations confirm the plain meaning of "participate," "directly or indirectly," and "affairs." In particular, no one disputes that "participate" has a settled, precise meaning and use in legal contexts ancestral to RICO; that it there exists to impose liability on those who merely "assist," "have a part" or "share" in misconduct largely initiated or advanced by others. At the time RICO was adopted, this meaning of "participate" was settled not only in the federal securities cases we earlier noted, but in numerous state court cases as well. See J. Wolens, *"Hidden Gold" in the Blue Skies Laws*, 20 Sw. L.J. 578 (1966) (collecting cases); G. Elden, *Litigation Under Illinois Securities Law*, 60 Ill. B.J. 28 (1971); *Davis v. Walker*, 104 N.W.2d 479, 490 (Neb. 1960); *Wharton v. Fidelity-Baltimore Nat'l Bank*, 158 A.2d 887, 893 (Md. 1960); *Kansas City v. Caresio*, 447 S.W.2d 535, 537 (Mo. 1969).

Arthur Young (but not its amici) concedes that "conduct" (particularly in light of (C) and (D), below) can and should be given its plain, broad meaning (*i.e.*, as equivalent to "carrying out" or "carrying on"). In light of these concessions, Arthur Young must agree that the "participation" element of section 1962(c) uses the words of everyday English broadly and in a way that non-lawyers understand. Accordingly, Arthur Young must also agree that it should not have received summary judgment if there is evidence that it shared or assisted, even if indirectly, in carrying on any aspect of the Co-Op's affairs.

(C) *Context* is also important: on this, all brief-writers agree. Presumably those who choose a statute's words do not intend one of them to nullify or render superfluous another. Moreover, no sensible person can deny that a word's meaning is influenced by surrounding

words. Here "conduct" is surrounded by words which (all admit) have about as great a breadth as statutory words can have. Thus, even if "conduct" implied some element of "control," the statute would require only a "participation" in that control, such participation could be "indirect," and it could pertain to any of the "affairs" of the enterprise.

Moreover, unless a "pattern" of bribes, extortion, or fraud at least sometimes amounts to indirect participation in the "conduct" of "affairs," RICO will not apply to most predicate acts. Thus, to take plausible cases, RICO seems designed to cover X if X repeatedly bribes state commissioners to influence their decisions, or repeatedly threatens an officer of a company to cause the company to pay X money. Does it aid a court's analysis to ask, in these cases, whether X "controls" the commission or the company? We submit it is clearer and truer to statutory expression to analyze directly whether X has "participated" in the "conduct" of those enterprise's "affairs."

We also refer the Court to another section of RICO itself (section 1962(b)) for proof that Congress knew how to use the word "control" when it wanted to do so. (Section 1962(b) punishes anyone who, through a pattern of racketeering acts, acquires or maintains "control of" an enterprise.) Similarly, Congress has for years distinguished between "participant" and "controlling person" liability in the securities laws (which are incorporated into RICO). The main lesson of considering these provisions is that Congress deliberately chose *not* to say "control" (or "operation" or "management") in section 1962(c), and chose a broader word intentionally.

(D) *The purpose* of section 1962(c), as inferred from its language, is not to amplify *all* penalties and liabilities under predicate acts but to do so only against certain persons. For example, even though the enterprise itself may be a principal wrongdoer, it is not subject (at least by section 1962(c)) to RICO liabilities. Liabilities do attach, however, to those who merely "participate" "indirectly" in the "conduct" of that same enterprise's "affairs" through prohibited means. Given its plain words, section 1962(c) is designed to increase punishment and liability not just for insiders who use power they inherently have, but for outsiders (like Arthur Young here) who expand their own power to commit illegal acts by participation in a larger enterprise.

(E) *Formal legislative history*, such as a Senate report, may be considered when the language of the statute itself is ambiguous. This can be worth doing since the history is written contemporaneously by some of the people adopting the statute. But "some" is the problem. Had the original bill been worded to include the Senate report's language, would it have been amended in conference? passed the House? been vetoed? been supplemented by other provisions? been amended the next year? been held unconstitutional? Moreover, the statute's language may have changed *after* the report was written (which actually happened to the precise words at issue; see AFL-CIO Br. 18, 20) so that the legislative comments would not anticipate any alteration. (In any event, the legislative history specifically contemplates extending RICO to accountants or auditors.)

(F) Finally, the actions of *subsequent Congresses* can be of some utility when a party pressing for an exemption from the Court has previously sought similar relief from

Congress and left empty-handed. In this instance, AICPA has unsuccessfully lobbied Congress for the equivalent of an auditors' exemption from RICO.<sup>2</sup>

\* \* \*

Taken together, these factors preclude judicial creation of an auditors' exemption from RICO. The statutory words, context, and purpose are too broad to permit any such sweeping limitation. The legislative history, though indeterminate (perhaps inherently), on balance suggests no such exemption was intended.

In sum, there is no basis to restrict the application of section 1962(c) by selecting the most narrow definitions of the word "conduct" and then using the narrow definition of that single word to cut back dramatically on the broad and plain "participation" phrase actually chosen by Congress. As we show below, Arthur Young's response offers additional support for the proposition that Arthur Young *did* "participate," "directly or indirectly," in the "conduct" of the Co-Op's "affairs."

## II. ARTHUR YOUNG PARTICIPATED IN THE CONDUCT OF THE CO-OP'S AFFAIRS.

### A. The Co-Op's "Affairs" Include The Preparation Of Its Pre-Audit Financial Statements.

Some of Arthur Young's most telling concessions occur when it describes the role of the textbook auditor

<sup>2</sup> E.g., *Proposed RICO Reform Legislation: Hearings on S.1523 Before the Senate Committee on the Judiciary*, 100th Cong., 1st Sess. 3-6 (1985) (statement of AICPA's Chairman); see also *RICO Reform Act: Hearing on S.438 Before the Senate Committee on the Judiciary*, 100th Cong., 1st Sess. 186-87 (1987) (AFL-CIO's statement regarding unions).

(a role that Arthur Young did *not* play here). The textbook (or "traditional") auditor "simply expresses an opinion on the *client's* financial statements." (AY Br. 30.) He or she opines only on whether financial facts "have been fairly presented . . . in the financial statements *issued by management.*" (*Id.*) "The financial statements are *management's responsibility.* The auditor's responsibility is to express an opinion on [them]." (AY Br. 31-32.) "What an auditor does – and the *most* that an auditor is *permitted* to do and still be considered independent – is test the transactions of the client *as reflected in the client's books and records . . . .*" (AY Br. 35 (emphases added).)

In addition, if an accountant drafts a client's financial statements, "the *client* must be sufficiently *knowledgeable* of the enterprise's activities and financial condition and the *applicable accounting principles* so that he can reasonably accept" responsibility for the statements. AICPA Rule 101-3, in *AICPA Accounting Standards* ET § 101.05, at 4413.

Finally, an auditor who helps draft financial statements cannot turn around and audit accounting decisions he has made:

[A]pplication of an independent viewpoint is particularly important with respect to judgment exercised in the *determination of appropriate principles and methods* applicable to the recording, classification, and presentation of financial data. By their nature such judgments cannot subsequently be evaluated on an impartial and objective basis by the same accountant who made them.

*Codification of Reporting Policies*, 6 Fed. Sec. L. Rep. (CCH) ¶38,335, at 38,590 (1986) (emphasis added); see also *In re*

*Thomas P. Reynolds Securities, Ltd.*, Sec. Ex. Act Release No. 29689, at 4 (Sept. 16, 1991) ("A company may, of course, rely on an outside firm to prepare its books of accounts and financial statements. However, once an accounting firm performs those functions, it has become identified with management and may not perform an audit.")<sup>3</sup>

So even the authorities relied upon by Arthur Young hold that it was part of the Co-Op's "affairs" to decide upon appropriate accounting principles, methods, and facts such as whether the Co-Op built or bought the gasohol plant, what it cost, and whether it had to be written down. Since Arthur Young did those things *on its own*, it plainly participated in the "conduct" of the Co-Op's affairs to that extent.

#### **B. Arthur Young Did Not Perform Traditional Auditing Activities And Nothing More.**

Even if the "traditional auditing activities" test offered by Arthur Young were proper, Arthur Young

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<sup>3</sup> In short, an auditor cannot become a Gilbert and Sullivan parody by auditing himself:

Pooh-Bah: [A]s Pay-master-General, I could so cook the accounts . . . that as Lord High Auditor I should never discover the fraud. But then, as Archbishop of Titipu, it would be my duty to denounce my dishonesty. . . .

Ko-Ko: That's extremely awkward.

*The Mikado*, Act I, Sc. I (1885).

plainly would fail it here. First, there is the un rebutted expert evidence regarding Arthur Young's wholesale failure to comply with the AICPA's own Generally Accepted Auditing Standards ("Standards"), of which there are only ten. At trial, an audit partner from Touche Ross & Co. testified as an expert witness that Arthur Young violated at least *six* of the ten Standards. (Trans. XIV:157; see also *id.* at 158-222 (explaining conclusions).) Significantly, Arthur Young did not offer any expert from its own ranks, from another major accounting firm, from AICPA, or from anywhere else to testify that it had met the standards of the auditing profession.

Next, Arthur Young is forced to concede so many of the principal facts<sup>4</sup> that it eventually rests its case that it was a "mere auditor" on four demonstrably false propositions: (1) that the Co-Op's financial statements (which Arthur Young admits it prepared (AY Br. 8)) "*were based on the records maintained by the Co-Op itself or its subsidiary, White Flame*" (AY Br. 8 (emphasis added); see also *id.* 32); (2) that Arthur Young's "audit judgments were reached after consultation" with Co-Op management,

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<sup>4</sup> In addition to the huge number of facts (Pet. Br. 6-18) conceded by silence, Arthur Young affirmatively agrees that: White and Dooley invested their *own* funds in 1979 to build a gasohol plant, which developed huge problems by 1980, when it was worth only \$444,000 to \$1,500,000 (AY Br. 4-5); AY booked the plant at \$4,500,000, creating a positive net worth of \$2,600,000 (AY Br. 12); and by putting those numbers without explanation into condensed financial statements handed out to Co-Op members at the annual meetings, the members were materially misled (AY Br. 12-13).

notably Jack White and Kirit Goradia (AY Br. 8 n.7, relying exclusively on Drozal's testimony, Trans. IX:227-29); (3) that Arthur Young put the board on "full notice" of the Co-Op's financial condition (AY Br. 6, 10-11); and (4) that Arthur Young was not involved in the sale of demand notes (AY Br. 3).<sup>5</sup>

(1) '*Based on the records.*' Arthur Young admits that it created the Co-Op's financial statements. Nevertheless, Arthur Young seeks to absolve itself of responsibility by asserting that its financial statements "were based on the records maintained by the Co-Op itself or its subsidiary, White Flame Fuels." (AY Br. 8.)

In fact, before Arthur Young became involved with the Co-Op in 1981, the gasohol plant had never appeared on any Co-Op financial document as a Co-Op asset. Indeed all company records, and numerous critical ones (tax returns, minutes, third-party documents), showed that the Co-Op did not own the plant in 1979 and

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<sup>5</sup> Arthur Young criticizes the Class for relying on the trial record (AY Br. 1-2 & n.1) and then proceeds throughout its brief to cite almost exclusively to that record, as both parties have done in every prior appellate brief and as the courts below have done in every prior opinion. The reason all counsel cite the trial record is that after the close of all evidence and before the jury retired, plaintiffs specifically made the trial record part of the summary judgment record by asking the district court to reconsider the prior summary judgment ruling on the RICO claim based on the entire record to the end of trial. The district court agreed to do so ("I'm going to go ahead and rule on that" (Trans. XV:49)) and then, as expected, reaffirmed his decision against the Class ("RICO is not going to go to the jury" (*id.* at 51)). The understandable goal was to create a single record for all issues on appeal.

acquired it in 1980. (Pet. Br. 11 n.6.) Far from basing anything on those documents, Arthur Young in disregard of them created the “blatant fiction” (CAJA 154-55) that the Co-Op had always owned the plant. At trial, Arthur Young tried to justify that fiction *not* by claiming that it was based on Co-Op records, but by asserting that it was based on Arthur Young’s own view of “economic realities.”

This implausible argument was rejected by the jury and the courts below. The entire record supports the Eighth Circuit’s summary: “Arthur Young was the *source* of some of the information that was *not disclosed*, e.g., the assumption about the Co-Op always having owned White Flame . . . .” (JA 304 (emphasis added).)

Also, the financial statements Arthur Young created contradicted all Co-Op records relating to recoverability of the “cost” of the gasohol plant. Co-Op records showed that the plant would never cover even its operating expenses (Pet. Br. 13-14 & n.7), which fact required a writedown of the plant from its cost value to its net realizable value. Arthur Young unilaterally decided not to write down the plant.<sup>6</sup>

Finally, Drozal under oath admitted that he derived the ridiculously-inflated \$4,300,000 cost figure. That is true even though, as Arthur Young now admits (and – incredibly – tries to use affirmatively), Drozal blatantly

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<sup>6</sup> This is a good place to correct a mistake in our earlier brief: Kuykendall was an outside accountant and auditor. At Pet. Br. 3, we called him an internal accountant. Arthur Young (AY Br. 8 n.7) repeats this erroneous description as well.

lied about *how and why* he did so (not *whether* he did so). (See AY Br. 8 n.7.)

(2) ‘*After consultation*’ with White and Goradia. While Drozal (Arthur Young’s partner-in-charge) testified that he spoke with or interviewed White, Goradia, and unnamed persons at the gasohol plant, he did not claim (as Arthur Young now does) that he discussed Arthur Young’s “audit judgments” with them. (See Trans. IX:227-29.)

Drozal admitted that he knew that he could not rely on White (“If he told me it was raining outside, I’d look out the window.”). (*Id.* 230.) Neither Goradia nor White ever told Drozal that the Co-Op had always owned the plant; indeed, White’s records and the “friendly lawsuit” said the opposite. Neither person said the plant should not be written down – neither was consulted on this. Goradia never said the plant cost \$4,300,000 to build; indeed, he refused in writing to sign a standard client representations letter (*i.e.*, refused to take responsibility for the accuracy of any of the Co-Op’s financial statements or records). (JA 254.)

(3) ‘*Full notice*’ to the Board. The jury, the district court, and the Eighth Circuit all concluded that Arthur Young failed to disclose material facts to the Co-Op’s members, management, and board. (See JA 304.) The case was tried, decided, and affirmed as a nondisclosure case. (JA 299.) It is thus established (or, at the least, there is a genuine issue of fact) that: the Co-Op was insolvent; Arthur Young itself prepared statements that concealed the insolvency; to do so, it “originated” the fraud here; it never disclosed its key unilateral financial decisions; it

created records for the Co-Op materially contrary to what Arthur Young knew to be true; it misled members at two annual meetings; it deceived a government agency, the USDA; and no one else participated in these concealments because no one but Arthur Young even knew they were taking place.

The jury obviously did not believe that Arthur Young put the board on "full notice" of the Co-Op's financial condition. Though Arthur Young did reveal some information, it concealed many material facts, including the fraudulent decisions that went into the drafting of the financial statements. Arthur Young thereby prevented anyone else from knowingly adopting the statements on the Co-Op's behalf.

(4) *'Selling' demand notes.* It is true that Arthur Young did not physically sell demand notes to individual members of the Class. But Arthur Young's creation and presentation of the Co-Op's financial information was far more important to the Co-Op's note program than any one note sale to a Class member. It was Arthur Young's persistent depiction of the Co-Op as a solvent entity that allowed the Co-Op to continue to make note sales and keep the Co-Op afloat for over two years. As the Eighth Circuit found, "Arthur Young had to know that good news about the Co-Op's finances, or even the lack of bad news, would cause people to invest in the Co-Op." (JA 306.) Indeed, the Eighth Circuit went even further by holding that "Arthur Young 'materially aided' in the sale of demand notes." (JA 287.)

All of these facts must be viewed in a light favorable to us, with all reasonable inferences drawn our way. Although persons in addition to Arthur Young were associated with the Co-Op and although some of them had significant responsibilities, only Arthur Young was involved in the creation and presentation of the critical financial information, only Arthur Young originated the fraud, and only Arthur Young maintained it for nearly three years. At the very least, there is a question of material fact as to whether Arthur Young "participated," "directly or indirectly," in the "conduct" of this most important part of the Co-Op's "affairs."

### III. ARTHUR YOUNG CANNOT NOW RAISE ISSUES NOT INCLUDED IN ANY CERTIORARI PETITION AND NOT DECIDED BY ANY LOWER COURT.

"Only the questions set forth in the petition [for a writ of certiorari], or fairly included therein, will be considered by the Court." Sup. Ct. R. 14.1(a). Respondent may not "raise additional questions or change the substance of the questions already presented," Sup. Ct. R. 24.1(a), 24.2, even to include "complementary" or "related" issues. *Yee v. City of Escondido, Cal.*, \_\_\_ U.S. \_\_\_, 112 S. Ct. 1523, 1533-34 (1992); *Air Courier Conf. of America v. American Postal Workers Union*, \_\_\_ U.S. \_\_\_, 111 S. Ct. 913, 917 (1991); *Kamen v. Kemper Fin. Services*, \_\_\_ U.S. \_\_\_, 111 S. Ct. 1711, 1716-17 n.4 (1991). "The Court decides which questions to consider through well-established procedures; allowing the able counsel who argue before us to alter these questions or to devise additional questions at the last minute would thwart this system." *Taylor*

*v. Freeland & Kronz*, \_\_\_ U.S. \_\_\_, 112 S. Ct. 1644, 1649 (1992).

### A. Arthur Young's "Pattern" Argument

Whether Arthur Young's securities frauds may constitute a "pattern" under section 1962(c) "is not the question presented by the petitioners in this case"; that Arthur Young admits. (AY Br. 43.) Arthur Young's own petition raised only securities law issues, and Arthur Young declined to file a cross-petition on the RICO issues it now seeks to interject.

The district court decided the pattern issue under the Eighth Circuit rule overruled in *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 235 (1989). Accordingly, no court has applied *H.J. Inc.* to the facts here (nor have the parties taken discovery on any matters newly-relevant under *H.J. Inc.*) If the Court does not ordinarily make decisions without "lower court opinions squarely addressing the question," *Yee*, 112 S. Ct. at 1534; *Taylor*, 112 S. Ct. at 1649; *Air Courier*, 111 S. Ct. at 913, that result is especially appropriate on an issue so complex and fact-intensive.<sup>7</sup>

<sup>7</sup> Arthur Young contends that its fraudulent acts were not "continuing" within the meaning of *H.J. Inc.* because they encompassed only "a few months" and consisted of "one accounting decision concerning one asset of one company." (AY Br. 44.) The gasohol plant alone embraced events from late 1981 until early 1984 and included two false annual financial statements, deceptions at two annual meetings, deceptions at numerous regular and special board meetings, and deception of a federal

(Continued on following page)

### B. Arthur Young's Constitutional Vagueness Claim

Arthur Young asks the Court to hold RICO unconstitutional on vagueness grounds. Since there is no First Amendment issue, this "vagueness claim must be evaluated as the statute is applied to the facts of this case." *Chapman v. United States*, \_\_\_ U.S. \_\_\_, 111 S. Ct. 1919, 1929 (1991) (citing *United States v. Powell*, 423 U.S. 87, 92 (1975)). No court in this case could make such an evaluation because Arthur Young never raised the issue until after the Eighth Circuit's first decision was reversed by the Court and the case was remanded. The Eighth Circuit totally ignored the argument thus improperly injected.

Not only did Arthur Young waive the issue, *Daley v. Webb*, 885 F.2d 486, 488 (8th Cir. 1989); *Rogers v. Masem*, 788 F.2d 1288, 1292 (8th Cir. 1985), but, as in *Singleton v. Wulff*, 428 U.S. 106, 119-20 (1976), the Court can "have no idea what evidence, if any, petitioner would, or could,

(Continued from previous page)

agency. And Arthur Young committed many frauds totally unrelated to the gasohol plant. There is the \$1.5 million note discussed at Pet. Br. 15 and CAJA 90; the self-dealing transactions for which White was convicted; and the concealment of the Co-Op's payment of fees to White's lawyers, Ball & Mourtton, and experts, Arthur Young. These facts present a *prima facie* case of "continuity." See *Swistock v. Jones*, 884 F.2d 755, 759 (3d Cir. 1989) (conduct lasting fourteen months sufficient to fulfill continuity requirement); *Shearin v. E.F. Hutton Group*, 885 F.2d 1162, 1166 (3d Cir. 1989) (two years); *Atlas Pile Driving Co. v. DiCon Fin. Co.*, 886 F.2d 986, 994 (8th Cir. 1989) (three years). See generally Pet. Br. 6-18 for more pattern evidence although, on remand, we would seek additional discovery.

offer in defense of this statute . . . this is because petitioner has had no opportunity to proffer such evidence."<sup>8</sup> *Accord Browning-Ferris Indus. v. Kelco Disposal, Inc.*, 492 U.S. 257, 277 & n.23 (1989) ("absence of a developed record on [constitutional] issues" belatedly raised provides good reason not to decide such issues).

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### CONCLUSION

For the foregoing reasons, the Court should reverse the decision below and remand the case for further proceedings on the Class' RICO claim.

Respectfully submitted,

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<sup>8</sup> The 20 pages allotted for us to respond to over 100 pages of amici and respondent's briefs obviously leaves us no space to deal with the merits of two such far-reaching claims as the ones newly raised by Arthur Young. If for some reason the Court wants to decide either on the merits, we respectfully ask leave to file an additional brief addressing these issues.

③  
No. 91-886

Supreme Court, U.S.  
FILED

40-07 APR 9 1992

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**In the Supreme Court of the United States**

OCTOBER TERM, 1991

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BOB REVES, ET AL., PETITIONERS

v.

ERNST & YOUNG

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ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE  
SUPPORTING PETITIONERS

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### **QUESTION PRESENTED**

Whether the phrase "to conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs through a pattern of racketeering activity" in the RICO statute requires proof that the defendant exercised control over the management or operation of the enterprise.

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## In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-886

BOB REVES, ET AL., PETITIONERS

v.

ERNST &amp; YOUNG

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE  
SUPPORTING PETITIONERS

## INTEREST OF THE UNITED STATES

The Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. 1961 *et seq.*, imposes criminal and civil liability for specified forms of racketeering activity. This case presents an issue that arises in both criminal and civil RICO actions: Whether the phrase "to conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs through a pattern of racketeering activity" in 18 U.S.C. 1962(c) requires proof that the defendant exercised control over the management or operation of the enterprise. The United States prosecutes a wide variety of criminal activity under the RICO statute and on occasion institutes civil actions under the statute. In our view, the court of appeals' holding that the defendant must have participated in operating or managing the enterprise in order to be held liable under Section 1962(c) is unfounded and

(1)

threatens to impede the government's enforcement of the RICO statute. Accordingly, the United States has a significant interest in the Court's resolution of this case.

### STATUTE INVOLVED

The pertinent provision of the RICO statute, 18 U.S.C 1962, is set forth in an appendix to this brief.

### STATEMENT .

1. Petitioners are a class of shareholders and purchasers of demand notes in the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op). The Co-op's Board of Directors was elected by its membership, which consisted of local farmers. Day-to-day management of the Co-op was delegated to a general manager. In 1952, the Board appointed Jack White as general manager. Pet. App. A6. In 1979, White and one other individual formed an independent venture to construct a gasohol plant. White borrowed extensively from the Co-op to finance the plant, eventually running up a debt to the Co-op of \$4 million. Although the plant was completed in April 1980, it soon experienced serious financial difficulties. *Id.* at A8-A9.

In September 1980, White was indicted for federal tax fraud. Pet. App. A9. At White's criminal tax trial, Harry Erwin, an accountant, testified on White's behalf. Erwin was the managing partner of Russell Brown and Company, a local accounting firm. In January 1981, White was convicted. *Id.* at A12-A13. Soon afterward, the Co-op retained Erwin's firm to perform the Co-op's 1981 financial audit. *Id.* at A13-A14. Erwin's firm was acquired by Arthur Young and Company, which later became respondent Ernst & Young. *Id.* at A13 n.5.

After White's indictment, the Co-op Board of Directors, at White's request, voted to purchase the gasohol plant. Pet. App. A9-A10. Upon starting the 1981 audit process, respondent immediately learned that the Co-op's financial reporting of the gasohol plant posed considerable problems.

The 1980 financial statements for the Co-op had been prepared by its former accountant, who stood convicted of tax fraud along with White. Realizing that those statements were not reliable, respondent made its own effort to determine the value of the Co-op's interest in the gasohol plant.<sup>1</sup> As a result of that effort, respondent developed a value for the plant of \$4 million. That figure, although purportedly derived by respondent independently, matched exactly the value developed by the Co-op's former accountant, even though that accountant had based his valuation on fabricated construction costs and expenses. *Id.* at A16. Respondent's value also significantly overstated the plant's actual value, which was at most \$1.5 million. If the plant had been valued accurately, the Co-op would have been insolvent. *Id.* at A14-A20.

In April 1982, respondent presented its audit report to the Co-op's Board. Pet. App. A20-A21. The report indicated that respondent had "some doubt" that the Co-op would recover its investment in the gasohol plant and was "unable to satisfy" itself about the proper carrying value of the plant. *Id.* at A21. The attached financial statements showed the gasohol plant as representing more than a quarter of the Co-op's assets. *Ibid.* Respondent did not advise the Board about the method used to determine the value of the gasohol plant, nor did it ever ask the Co-op's Board or management for projections on whether the plant would succeed. *Id.* at A23.

On May 27, 1982, the Co-op held its annual meeting. The Co-op prepared condensed financial statements from respondent's submissions, and distributed the condensed statements to members. The condensed statements listed the gasohol plant as a \$4.5 million asset, but did not disclose that the plant had experienced losses of \$1.2 million.

<sup>1</sup> Respondent did not seek or obtain a representation letter from management stating that the Co-op's financial records were accurate and prepared in accordance with generally accepted accounting principles. Pet. App. A30 n.11.

Nor did the condensed statements explain that respondent had questioned whether the cost of the plant was recoverable. Pet. App. A23-A24.<sup>2</sup> Representatives of respondent attended the meeting and made a five-minute presentation discussing the condensed financial statements and the Co-op's financial picture. *Id.* at A25-A26. In response to members' questions, respondent disclosed that the plant had lost \$1.2 million. Respondent failed, however, to disclose the way in which it had valued the plant. Respondent also failed to disclose that it could not satisfy itself regarding the carrying value of the plant, and that a write-down of the plant would render the Co-op insolvent. *Id.* at A26-A27.

Respondent was again retained for the 1982 audit. It prepared an audit report substantially like the prior year's report.<sup>3</sup> Pet. App. A27-A31. The Co-op then undertook to draft condensed financial statements for its members. Respondent advised the Co-op that, without respondent's explanatory notes, the condensed statements would be misleading. The Co-op, however, distributed the condensed financial statements without respondent's notes and indicated that the statements were derived from respondent's annual audit. Respondent was aware that those statements were deficient, but it took no action. *Id.* at A32.

At the Co-op's annual meeting, respondent gave a three-minute financial report to members based on the condensed financial statements. It did not inform members that the statements were misleading. Nor did re-

<sup>2</sup> Respondent later concluded that the condensed financial statements were "misleading." Pet. App. A28.

<sup>3</sup> Respondent drafted representation letters for management's signature that stated that the Co-op's financial statements were accurate and prepared in accordance with generally accepted accounting principles. The Co-op's new general manager signed such a letter, but its chief financial officer refused to do so. That is ordinarily grounds for an auditor to disclaim an opinion or to qualify its audit report, but respondent did neither. Pet. App. A29-A30.

spondent disclose that it could not satisfy itself about the value of the gasohol plant and that a write-down of the plant would make the Co-op insolvent. Pet. App. A33-A34.

Within a year, the Co-op declared bankruptcy. According to its bankruptcy filings, one of the Co-op's major problems was the financial condition of the gasohol plant. Pet. App. A35-A36. As a result of the bankruptcy, the Co-op's demand notes became unredeemable. *Id.* at A36.

2. The trustee appointed by the bankruptcy court filed suit against respondent and others on behalf of the Co-op and certain demand noteholders. Pet. App. A36-A37. The complaint alleged, *inter alia*, that respondent had violated Section 1962(c) of the RICO statute, 18 U.S.C. 1962(c), by associating with an "enterprise"—the Co-op—and conducting or participating in the conduct of the Co-op's affairs through a pattern of mail, wire, and securities fraud violations.<sup>4</sup> As relief, the complaint sought treble damages under 18 U.S.C. 1964(c). Complaint ¶¶ 154-163.

In 1985, the district court certified a class of purchasers of demand notes during the relevant period. The court denied respondent's motion to dismiss the RICO count, but granted its motion for summary judgment on that claim. Pet. App. A36-A37, A58-A60. The court held that respondent could not be shown to satisfy RICO's requirement that a defendant "conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs." 18 U.S.C. 1962(c). In so holding, the district court relied on the statement in *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008

<sup>4</sup> The RICO statute defines an "enterprise" as including "any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." 18 U.S.C. 1961(4). "Racketeering activity" is defined to include, *inter alia*, "any act which is indictable" under 18 U.S.C. 1341 or 1343, the mail fraud and wire fraud statutes, or "any offense involving \* \* \* fraud in the sale of securities." 18 U.S.C. 1961(1)(B) and (D).

(1983), that the "conduct or participate" element "ordinarily will require some participation in the operation or management of the enterprise itself."<sup>5</sup> Pet. App. A58-A60. According to the district court, respondent's auditing activities did not reflect the requisite "degree of management" because they involved only the review of completed transactions and the certification of the Co-op's records as fairly portraying its financial status. *Id.* at A60.<sup>6</sup>

3. The court of appeals affirmed the entry of summary judgment in respondent's favor on the RICO claim. Pet. App. A44-A48. Applying the standard set forth in *Bennett v. Berg*, *supra*, the court of appeals stated that respondent's "involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings." Pet. App. A46. Although noting that "[i]n the course of this involvement it is clear that [respondent] committed a number of reprehensible acts," the court of appeals concluded that "these acts in no way rise to the

<sup>5</sup> In *Bennett*, residents of a retirement community filed a RICO claim against the owners, financiers, lawyers, and accountants for the community, alleging that they had conducted the financial affairs of the community through fraudulent activities that caused losses to the plaintiffs. The court of appeals held that the complaint stated a claim under RICO, but, in remanding for further proceedings, expressed concern that the plaintiffs may not have adequately pleaded "the requisite degree of participation in or conduct of the affairs of the community" on the part of the outside financiers, lawyers, and accountants. 710 F.2d at 1364.

<sup>6</sup> The case went to trial on other claims, and the jury found, *inter alia*, that respondent had committed securities fraud in violation of federal and state law. See Pet. App. A4. The district court entered judgment against respondent in the amount of \$6,121,652, subject to certain credits from settlements. *Id.* at A42. The court of appeals initially reversed, holding that the demand notes were not securities under the federal securities laws. *Id.* at A43. This Court reversed that holding. *Reves v. Ernst & Young*, 494 U.S. 56 (1990). On remand, the court of appeals affirmed the judgments on the securities fraud claims. *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1333 (8th Cir. 1991).

level of participation in the management or operation of the Co-op." *Ibid.*

## SUMMARY OF ARGUMENT

A. RICO makes it unlawful for a person associated with an enterprise "to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity." 18 U.S.C. 1962(c). That provision does not require proof that the defendant managed or operated an enterprise, or participated in doing so, in order for the defendant to be held liable. A person who "conducts" an activity, in the ordinary sense of the word, may be either a person who leads the activity or one who participates in carrying it forward. That meaning accords with Congress's express inclusion, in the class of persons subject to liability, of those who "participate" in conducting the enterprise's affairs "directly or indirectly."

The legislative history, to the extent it is relevant, offers no support for the court of appeals' "operation or management" test. Nor can such a test be reconciled with RICO's purposes. One of the principal objectives of the RICO statute is to prevent the infiltration of legitimate businesses by criminal actors. The concept of infiltration applies to outsiders who usurp or corrupt the functions of an enterprise, even when they do not assume managerial or operational control of the entity. Accordingly, a "conduct or participate" test that limits RICO's reach to high-level actors who gain control of an enterprise would defeat one of the central purposes of the statute.

B. RICO's "conduct or participate" element requires that the defendant take part in carrying out the activities of the enterprise by means of a pattern of predicate crimes. The requisite connection may be established in various ways, in keeping with the diversity of relationships that defendants can have with the enter-

prise. In general, the "conduct or participate" requirement is satisfied whenever the defendant (a) engages in racketeering activity through the enterprise that furthers the enterprise's objectives; (b) uses the enterprise's resources or his association with the enterprise to facilitate his crimes; or (c) engages in criminal activity designed to corrupt the enterprise's actions.

C. The courts below applied an incorrect legal analysis in granting summary judgment to respondent. Whether respondent sufficiently participated in the conduct of the Co-op's affairs does not turn on whether it operated or managed the Co-op; it turns instead on the nature of respondent's role in preparing and explaining the Co-op's financial information through the alleged pattern of false and misleading statements. The case should be remanded to the court of appeals for further consideration of that issue.

### ARGUMENT

#### **THE RICO STATUTE DOES NOT REQUIRE THAT A DEFENDANT PARTICIPATE IN THE MANAGEMENT OR OPERATION OF AN ENTERPRISE IN ORDER TO BE HELD LIABLE UNDER 18 U.S.C. 1962(c)**

##### **A. The Language And Purposes Of RICO Are Inconsistent With A Requirement That The Defendant Manage Or Operate The Enterprise**

On its face, RICO contains no requirement that a defendant manage or operate an enterprise, or participate in those functions, in order to be liable under 18 U.S.C. 1962(c). The statute requires that the defendant have a connection with the enterprise in three respects: first, the defendant must be "employed by or associated with" the enterprise; second, the defendant must "conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs"; and third, the defendant's involvement in the enterprise's affairs must be "through a pattern of racketeering activity." Nothing in any of those provisions suggests that the defendant must man-

age, lead, control, or operate the enterprise in order to be subject to liability under RICO.<sup>7</sup>

1. *Statutory language.* The word "conduct" is used as both a verb and a noun in Section 1962(c); a person is liable if he "conduct[s] \* \* \* [the] enterprise's affairs" through the proscribed pattern, or if he "participate[s] \* \* \* in the conduct of such enterprise's affairs." It is appropriate to give the word "conduct" a similar construction in those two phrases, see *Sorenson v. Secretary of the Treasury*, 475 U.S. 851, 860 (1986),

<sup>7</sup> A majority of the courts of appeals do not apply a management or operation test, but examine the defendant's connection to the enterprise under a standard more in keeping with the breadth of the statutory language. See *United States v. Scotto*, 641 F.2d 47, 54-55 (2d Cir. 1980) (the "conduct" element is satisfied where "(1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise"), cert. denied, 452 U.S. 961 (1981); *United States v. Provenzano*, 688 F.2d 194, 200 (3d Cir.) (same), cert. denied, 459 U.S. 1071 (1982); *United States v. Yarbrough*, 852 F.2d 1522, 1544 (9th Cir.) (same), cert. denied, 488 U.S. 866 (1988); *United States v. Cauble*, 706 F.2d 1322, 1333 (5th Cir. 1983) (the "conduct" element entails a showing, where the enterprise is a legitimate business, that "(1) the defendant has in fact committed the racketeering acts as alleged; (2) the defendant's position in the enterprise facilitated his commission of the racketeering acts, and (3) the predicate acts had some effect on the lawful enterprise"), cert. denied, 465 U.S. 1005 (1985); *United States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988) (same). See also *Bank of America v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986) ("conduct" \* \* \* simply means the performance of activities necessary or helpful to the operation of the enterprise"). In general, these cases integrate into a single inquiry the issue whether the defendant "conducted or participated" in the conduct of the enterprise's affairs, and whether he did so "through" a pattern of racketeering activity. That approach is consistent with RICO's focus on the relationship between criminal conduct and the enterprise. The nature and method of the defendant's crimes must be examined to determine whether he has "conducted or participated" in the conduct of the enterprise's affairs "through" the pattern of predicate crimes.

and to determine the meaning of the statutory language in light of its context and the structure of the statute as a whole, see *King v. St. Vincent's Hospital*, 112 S. Ct. 570, 574 (1991).

a. The court of appeals read the term "conduct" restrictively, to apply only to a person who participates in the "operation or management" of an enterprise. See *Bennett v. Berg*, 710 F.2d at 1364, citing *United States v. Mandel*, 591 F.2d 1347, 1375 (4th Cir. 1979) ("the 'conduct or participate' language in § 1962(c) require[s] some involvement in the management or operation of the business"), vacated on other grounds, 602 F.2d 653, cert. denied, 445 U.S. 961 (1980).<sup>8</sup> That construction, however, is contrary to the "ordinary meaning" of the term "conduct." See *Russello v. United States*, 464 U.S. 16, 21 (1983). It is generally recognized that persons who take part in carrying out the activities of an enterprise "conduct" the enterprise's affairs, even if they do not lead or direct its activities. The definition of the verb "conduct" includes the meaning, "To direct, manage, carry on (a transaction, process, business, institution, legal case, etc.)." 3 *Oxford English Dictionary* 691 (2d ed. 1989). That definition, however, pointedly adds: "The notion of direction or leadership is often obscured or lost; e.g. an

<sup>8</sup> *Mandel*, which was the sole authority cited by the court of appeals in *Bennett v. Berg*, gave scant attention to the level and quality of the relationship that the defendant's crimes must have to the enterprise. *Mandel* held only that the transfer of a legitimate business to the defendant as a payoff for fraudulent activity did not amount to conducting or participating in the conduct of *that* business through the predicate crimes. 591 F.2d at 1376. A later decision of the Fourth Circuit applied RICO to an outsider who committed criminal acts through use of the enterprise's resources, without managing, operating, or controlling it. See *United States v. Webster*, 639 F.2d 174 (1981), modified, 669 F.2d 185, 187 (upholding a RICO conviction where the defendants' participation in the conduct of the enterprise's affairs consisted of using the telephone, facilities, and personnel of an entertainment club as a base for carrying out narcotics transactions), cert. denied, 456 U.S. 935 (1982).

investigation is *conducted* by all those who take part in it." *Ibid.* To the same effect is *Webster's Dictionary of Synonyms* 184 (1942), which states that "[c]onduct may imply the act of an agent who is both the leader and the person responsible for the acts and achievements of a group having a common end or goal \* \* \*, but often the idea of leadership is lost or obscured, and the stress is placed on a carrying on by all or by many of the participants."

There is no indication that Congress intended a narrower meaning in RICO. As this Court has noted, "the pattern of the RICO statute" is to "utiliz[e] terms and concepts of breadth." *Russello*, 464 U.S. at 21 (citing as an example the term "participate" in Section 1962(c)); see *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 497-498 (1985) ("RICO is to be read broadly" in accordance with "Congress' self-consciously expansive language and overall approach"). To substitute for the statutory term "conduct" a formulation that looks to "management," "significant control," or "running the show," *Yellow Bus Lines, Inc. v. Drivers Local Union 639*, 913 F.2d 948, 954 (D.C. Cir. 1990) (en banc), cert. denied, 111 S. Ct. 2839 (1991), reads a limitation into RICO that Congress did not enact.

This Court has previously rejected judicially fashioned tests that would impose severe restrictions on RICO's

<sup>9</sup> The D.C. Circuit is the only court of appeals since *Bennett v. Berg*, *supra*, to have embraced a "management or operation" standard, and it did so in a fashion that appears to be even more restrictive than the Eighth Circuit's test. See *Yellow Bus*, 913 F.2d at 954 (Section 1962(c) requires "guidance, management, direction or other exercise of control over the course of the enterprise's activities."). *Yellow Bus* asserted that "'[c]onduct' is synonymous with 'management' or 'direction.'" *Ibid.*, quoting *Webster's Third New International Dictionary* 473 (1961). The quoted definition, however, is incomplete. The dictionary cited by the court of appeals defines "conduct" as "the act, manner, or process of carrying out (as a task) or carrying forward (as a business, government, or war); management; direction." *Ibid.* As we have noted, other dictionaries suggest that all participants who carry out an enterprise's business "conduct" its affairs.

broad scope. See *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 241 (1989) (rejecting "multiple scheme" limitation on RICO's "pattern" requirement because of lack of support in the statutory text or legislative materials); *Sedima*, 473 U.S. at 496 (rejecting racketeering injury requirement); *United States v. Turkette*, 452 U.S. 576, 583 (1981) (rejecting requirement that enterprise be a legitimate business). The "operation or management" limitation adopted by the court of appeals is equally unfounded.<sup>10</sup>

b. An "operation or management" approach also overlooks the statutory context of the specific prohibition. Section 1962(c) applies to any person who is "employed by or associated with" the enterprise, 18 U.S.C. 1962(c) (emphasis added)—a relationship that plainly includes lower-rung participants in organized criminal activity, as well as "outsiders" who have no official position within the enterprise. In addition, Section 1962(c) covers not only those who "conduct" the enterprise's affairs, but also those who "participate" in the conduct of those affairs, "directly or indirectly." That language is unmistakably broad. If Congress had intended to reach only those who had attained some "significant control" over the management or operation of an enterprise, see *Yellow Bus*, 913 F.2d at 954, it would not have employed terms that include indirect participants as well as those directly responsible for conducting the affairs of the enterprise.

Congress is quite familiar with language that restricts the reach of an offense to the "principal administrator"

<sup>10</sup> See *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987) ("conduct" in section 1962(c) does not mean "control" or "manage"); *United States v. Scotto*, 641 F.2d at 54 (rejecting the claim that "the jury was required to find that the predicate acts 'concerned or related to the operation or management of the enterprise'"); *Bank of America v. Touche Ross & Co.*, 782 F.2d at 970 ("It is not necessary that a RICO defendant participate in the management or operation of the enterprise.").

or "leader" of an enterprise. The Continuing Criminal Enterprise statute is written in precisely those terms. See 21 U.S.C. 848(b)(1) (prescribing penalties for "[a]ny person who engages in a continuing criminal enterprise \* \* \* if—such person is the principal administrator, organizer, or leader of the enterprise or is one of several such principal administrators, organizers, or leaders").<sup>11</sup> RICO, however, takes a different approach. As this Court has noted, "Congress drafted RICO broadly enough to encompass a wide range of criminal activity, taking many different forms, and likely to attract a broad array of perpetrators operating in many different ways." *H.J. Inc.*, 492 U.S. at 248-249.

2. *Legislative history.* To the extent that RICO's legislative history is relevant here, it provides no support for a narrowing "operation or management" gloss on Section 1962(c). For the most part, as is often the case, the legislative descriptions of Section 1962(c) merely track the statutory language. For example, the House Report states that "[s]ubsection (c) prohibits the conduct of the enterprise through the prohibited pattern of activity or collection of debt." H.R. Rep. No. 1549, 91st Cong., 2d Sess. 57 (1970). The Senate Report, in its section-by-section analysis of the bill, provides a similar statement while making clear that no minimal "percentage" of the enterprise's activities need be affected by racketeering to trigger the application of Section 1962(c). S. Rep. No. 617, 91st Cong., 1st Sess. 159 (1969).<sup>12</sup> That explanation

<sup>11</sup> Congress also made it a racketeering act under RICO, see 18 U.S.C. 1961(1)(B), when a person either "conducts" or "manages, supervises, [or] directs" an illegal gambling business in violation of 18 U.S.C. 1955(a) ("Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined not more than \$20,000 or imprisoned not more than five years, or both.").

<sup>12</sup> The Report notes that, unlike Section 1962(a), which provides an exception to the prohibition against investing funds derived from racketeering activity in an enterprise "where there is no re-

provides no support for the view that Congress envisioned that the defendant must manage or operate the enterprise before being exposed to RICO liability under Section 1962(c).

In *Yellow Bus*, 913 F.2d at 954, the court cited language in the Senate Report stating that RICO's goal is to attack "corruption in the acquisition or operation of business." S. Rep. No. 617, *supra*, at 81. That shorthand description, however, did not describe the reach of Section 1962(c); it appears in a passage of the Senate Report explaining the need for civil remedies analogous to divestiture in the antitrust field. Moreover, the description seems more pertinent to Section 1962(a), which prohibits a person from using or investing the proceeds of a pattern of racketeering activity "in acquisition of any interest in, or the establishment or operation of, any enterprise." 18 U.S.C. 1962(a). The fact that Congress explicitly prohibited the "operation" of the enterprise with racketeering proceeds in Section 1962(a) suggests that no "operation" requirement should be imported into Section 1962(c). Nor should a "control" requirement be added to Section 1962(c); Congress addressed "control" issues in Section 1962(b). See 18 U.S.C. 1962(b) (prohibiting, *inter alia*, the acquisition of "control" over an enterprise through a pattern of racketeering activity)<sup>13</sup>

sulting control in law or in fact to the investor," Section 1962(c) applies to any "conduct of the enterprise through the prohibited pattern"; there is no quantitative "limitation on the prohibition." S. Rep. No. 617, *supra*, at 159.

<sup>13</sup> A few general comments in the course of the floor debate addressed Section 1962(c) without purporting to analyze the "conduct" requirement. See, e.g., 116 Cong. Rec. 602 (1970) (remarks of Sen. Hruska) (RICO "is designed to remove the influence of organized crime from legitimate business by attacking its property interests and by removing its members from control of legitimate businesses which have been acquired or operated by unlawful racketeering methods. Stated simply, this legislation \* \* \* would \* \* \* prohibit any person employed by or associated with such an enterprise from conducting the enterprise's affairs by a pattern of racketeering ac-

3. *RICO's purposes.* Finally, the "operation or management" approach directly conflicts with RICO's major purpose: to attack the "infiltration of organized crime and racketeering into legitimate organizations." S. Rep. No. 617, *supra*, at 76. The "infiltration" of an enterprise can take place gradually and inflict serious injury long before it reaches the corporate boardroom. The concept of infiltration suggests actions by outsiders who usurp or corrupt the functions of an enterprise, without necessarily assuming formal management or control over its day-to-day operations. To wait until the enterprise has been captured at its upper echelons would thwart the purpose of the statute to arrest and prevent infiltration from its inception.

The "management or operation" test would have little significance if it did not serve to limit RICO's application to relatively high-level criminal actors.<sup>14</sup> Yet such a result

tivity."). In passing, some legislators used the word "operate" in discussing the prohibition reflected in Section 1962(c) without elaborating on that concept. *Id.* at 607 (remarks of Sen. Byrd); *id.* at 18,941 (remarks of Sen. McClellan). Only one reference in the House debate mentioned the idea of management, see *id.* at 35,196 (remarks of Rep. Celler) ("The conduct of the affairs of a business by a person acting in a managerial capacity, through racketeering activity is also proscribed."). That reference did not indicate that proof of management would be required to establish a violation, however. In any event, in light of the language Congress enacted, that solitary reference could not justify the interpretation advanced by the court of appeals. Cf. *Holmes v. Securities Investor Protection Corp.*, No. 90-727 (Mar. 24, 1992), slip op. 9 n.15.

<sup>14</sup> In fact, the court of appeals' test is highly ambiguous. The "management" prong appears to require more than the power to employ the enterprise as the vehicle for the predicate crimes, but the court has not said what more is required. The "operation" prong is even less clearly defined. For example, it is not clear whether "operation" of the enterprise includes the direction of routine business affairs. Even assuming that workable answers could be found, courts would have to provide them by interpreting words that are not in the statute. It makes little sense to develop a complex jurisprudence around a "test" that has no anchor in the relevant statutory provision.

would prevent RICO from reaching "[b]oth the captains and the lately enlisted foot soldiers in the enterprise." *Town of Kearney v. Hudson Meadows Urban Renewal Corp.*, 829 F.2d 1263, 1269 (3d Cir. 1987); *United States v. Elliott*, 571 F.2d 880, 903 (5th Cir.) ("the RICO net is woven tightly to trap even the smallest fish, those peripherally involved with the enterprise"), cert. denied, 439 U.S. 953 (1978).<sup>15</sup> RICO was intended to permit the dismantling of organized crime enterprises from top to bottom. See 116 Cong. Rec. 18,939 (1970) (remarks of Sen. McClellan). A test that would frustrate that objective is inconsistent with RICO's remedial aims.

**B. The "Conduct Or Participate" Element Requires That The Defendant Take Part In Carrying Out The Affairs Of The Enterprise Through A Pattern Of Unlawful Acts**

RICO's "conduct or participate" element requires a showing with respect to *how* the defendant used the enterprise in the course of his criminal activities: the defendant must be shown to have taken part in carrying out the activities of the enterprise by means of the prohibited predicate crimes. That requirement can be satisfied in a variety of ways, which are illuminated by the types of cases in which RICO has been traditionally applied.

1. *The general concept underlying the "conduct or participate" requirement.* RICO's "conduct or participate" element requires more than that the defendant be "employed by or associated with" the enterprise and engaged

<sup>15</sup> See also *United States v. DePeri*, 778 F.2d 963, 983 (3d Cir. 1985) (RICO applies to a "courier" or "go-fer"; the statute "draws no distinction between the foot soldier and the general"), cert. denied, 475 U.S. 1110 (1986); *United States v. Carlock*, 806 F.2d 535, 546 (5th Cir. 1986) (RICO applies to union member who received bribes), cert. denied, 480 U.S. 949 (1987); *United States v. Starnes*, 644 F.2d 673, 679 (7th Cir.) (RICO applies to a person recruited by the company president to burn a company building), cert. denied, 454 U.S. 826 (1981).

in crimes.<sup>16</sup> It also requires more than a coincidental or tangential connection between the enterprise, the defendant, and the pattern of racketeering activity. See *Averbach v. Rival Mfg. Co.*, 809 F.2d 1016, 1018 (3d Cir.) (filing a false interrogatory response was not participating in the conduct of the court's affairs), cert. denied, 482 U.S. 915 (1987); *United States v. Nerone*, 563 F.2d 836, 851-852 (7th Cir. 1977) (carrying out illegal gambling in a trailer park was not conducting the affairs of the corporation that operated the park), cert. denied, 435 U.S. 951 (1978); *United States v. Dennis*, 458 F. Supp. 197, 199 (E.D. Mo. 1978) (collecting unlawful debts on the premises of the employer did not constitute participating in the conduct of the employer's affairs through illegal debt collection), aff'd on other grounds, 625 F.2d 782 (8th Cir. 1980).

The requisite relationship, however, may be "direct" or "indirect," and it may flow from the defendant's conduct of the enterprise's affairs or from his simple participation in that conduct. As a result, there are various ways in which the "conduct or participate" requirement can be satisfied. Because the requirement may be met "in a variety of ways, \* \* \* it [is] difficult to formulate in the abstract any general test," *H.J. Inc.*, 492 U.S. at 241, as the formulations developed by the courts of appeals suggest.<sup>17</sup>

<sup>16</sup> The showing of employment by or association with the enterprise is a separate element of Section 1962(c). It can be satisfied in a number of ways, including through evidence of the defendant's position or role in the enterprise, see *United States v. Horak*, 833 F.2d at 1239; *United States v. Swiderski*, 593 F.2d 1246, 1249 (D.C. Cir. 1978), cert. denied, 441 U.S. 933 (1979); or evidence of his transactions with the enterprise, see *United States v. Bright*, 630 F.2d 804, 830 (5th Cir. 1980); *United States v. Yonan*, 800 F.2d 164, 167-168 (7th Cir. 1986), cert. denied, 479 U.S. 1055 (1987).

<sup>17</sup> The two leading formulations are represented by *United States v. Scotto*, *supra*, and *United States v. Cauble*, *supra*. See note 7, *supra*. Although cases applying these formulations have generally reached correct results, neither line of cases affords a precise guide

Devising a comprehensive formula to apply the "conduct or participate" element is difficult because of the diversity of ways in which defendants can interact with different types of enterprises. RICO applies to both legitimate and illegitimate enterprises;<sup>18</sup> to victim as well as aggressor enterprises;<sup>19</sup> and to insiders as well as outsiders.<sup>20</sup> The statute, however, draws no distinction between these categories. The specific activity of the defendant, therefore, will necessarily influence what factors are relevant in the analysis.

2. *Application of the "conduct or participate" requirement in particular cases.* As the following cases show, the "conduct or participate" requirement is generally satisfied whenever the defendant (a) engages in racketeering activity through the enterprise that furthers the enterprise's objectives; (b) uses the enterprise's resources or his association with the enterprise to facilitate his crimes; or (c) targets criminal activity so as to corrupt the enterprise's actions. Although these are not the

for application of the "conduct or participate" element in all settings. *Scotto's* suggestion that it is sufficient if the racketeering activity is "related to" the enterprise's activities (641 F.2d at 54) provides little concrete guidance and may suggest overbroad application of RICO, although it has not done so in decided cases. *Cauble*, on the other hand, makes it an element that the racketeering activity be "facilitated" by the defendant's "position in the enterprise" (706 F.2d at 1333). That approach may be too narrow in some situations, as it is not readily applicable to outsiders or to defendants who victimize the enterprise.

<sup>18</sup> *United States v. Turkette*, 452 U.S. 576 (1981).

<sup>19</sup> "The government need not prove that the racketeering activity 'benefitted' or 'advanced the affairs of' the enterprise \* \* \* [n]or must the government demonstrate that the enterprise itself was corrupt or that it authorized the defendant's conduct." *United States v. Cauble*, 706 F.2d at 1333 n.24.

<sup>20</sup> See *United States v. Gerver*, 809 F.2d 1291, 1301 (7th Cir. 1987); *Schacht v. Brown*, 711 F.2d 1343, 1360 (7th Cir.), cert. denied, 464 U.S. 1002 (1983); *United States v. Forsythe*, 560 F.2d 1127, 1135-1136 (3d Cir. 1977).

only situations in which the "conduct or participate" requirement can be satisfied, they represent characteristic applications of RICO that are at the core of the statute's coverage.

a. When the defendant's racketeering activity directly furthers the objectives of the enterprise, the "conduct or participate" element is satisfied. This approach readily applies to RICO prosecutions of persons involved with wholly criminal organizations. See *United States v. Watchmaker*, 761 F.2d 1459, 1475-1476 (11th Cir. 1985) (defendants participated in the conduct of motorcycle gang's affairs by engaging in acts of drug dealing and extortion with and at the behest of gang members), cert. denied, 474 U.S. 1100 (1986); *United States v. Ellison*, 793 F.2d 942, 950 (8th Cir.) (leader of white supremacy group directed arson activities involving that enterprise, which boosted members' morale and commitment), cert. denied, 479 U.S. 937 (1986).<sup>21</sup> It also applies to persons who further the illegal acts of businesses that exist for generally legitimate purposes. See *United States v. Horak*, 833 F.2d at 1239 (employee of subsidiary participated in the conduct of parent company by fraudulently procuring contracts for the subsidiary, which financially benefited the parent); *United States v. Zauber*, 857 F.2d 137, 150 (3d Cir. 1988) (pension fund officials furthered the affairs of a mortgage company by providing capital to that company for its loans in return for kickbacks solicited from company representatives), cert. denied, 489 U.S. 1066 (1989).

b. The defendant's use of the enterprise's resources or his association with the enterprise can also establish that

<sup>21</sup> RICO indictments of traditional organized crime families may also be brought on that approach. See *United States v. Angiulo*, 897 F.2d 1169, 1170-1177 (1st Cir.) (defendants carried out business of organized crime family through gambling, murder, and loan-sharking), cert. denied, 111 S. Ct. 130 (1990); *United States v. Indelicato*, 865 F.2d 1320, 1371 (2d Cir. 1988) (en banc) (defendants conducted the affairs of the "Commission" of La Cosa Nostra crime families through a pattern of murders), cert. denied, 493 U.S. 811 (1989).

he has conducted or participated in the conduct of the enterprise's affairs. Typically, this form of "conducting" or participating in the conduct of an enterprise's affairs involves the defendant's use of his position in the enterprise to attain illegal ends. See *United States v. Tillem*, 906 F.2d 814, 822 (2d Cir. 1990) (defendant was "enabled to commit extortion by reason of his position as an inspector and supervisor at the City Health Department"); *United States v. Robilotto*, 828 F.2d 940, 948 (2d Cir. 1987) (union official used influence over union (the enterprise) to place union welfare funds, in return for which he obtained personal loans), cert. denied, 484 U.S. 1011 (1988); *United States v. Qaoud*, 777 F.2d 1105, 1115-1117 (6th Cir. 1985) (public officials accepted bribes and obstructed justice in court system), cert. denied, 475 U.S. 1098 (1986); *United States v. Cauble*, 706 F.2d at 1341 (defendant used the private jet and funds of the enterprise, a partnership with his wife and son, to facilitate his smuggling activities); *United States v. LeRoy*, 687 F.2d 610, 617 (2d Cir. 1982) (defendant's position in union enabled him to obtain illegal payments and embezzle funds), cert. denied, 459 U.S. 1174 (1983); *United States v. Scotto*, 641 F.2d at 51 (union officials received payoffs from employers for reducing fraudulent compensation claims and assisting the employers in getting business). There is no requirement that such a defendant have a particularly high level of responsibility. *United States v. Kovic*, 684 F.2d 512, 516-517 (7th Cir.) (defendant used his position in police department to obtain kickbacks from vendors), cert. denied, 459 U.S. 972 (1982). Even outsiders who pay an entity to perform illegal acts can be held liable under RICO. *United States v. Manzella*, 782 F.2d 533, 538 (5th Cir.) (RICO conspiracy involving customers of arson enterprise), cert. denied, 476 U.S. 1123 (1986).

c. Racketeering activity that is targeted at the enterprise with the purpose or effect of corrupting its actions can establish the requisite conduct or participation. The classic example is the making of payments to representa-

tives of an organization to obtain improper action by the organization. *United States v. Yonan*, 800 F.2d at 167 (defense attorney who attempted to bribe prosecutor to influence the disposition of cases participated in the conduct of affairs of state's attorney's office); *United States v. Roth*, 860 F.2d 1382, 1390 (7th Cir. 1988) (lawyer who bribed judges participated in the conduct of the court's affairs), cert. denied, 490 U.S. 1080 (1989); *United States v. Bright*, 630 F.2d 804 (5th Cir. 1980) (bondsman who bribed sheriff participated in the conduct of the sheriff's office).

d. Those examples do not exhaust the ways in which the "conduct or participate" element may be satisfied; the ultimate inquiry is whether the defendant has carried out the affairs of the enterprise through a pattern of predicate crimes. Of relevance here, there is no exemption in the statute for purportedly "independent" professionals or advisers who carry out a pattern of predicate crimes in the course of advising or representing other entities.<sup>22</sup>

<sup>22</sup> The critical issue under RICO is the *relationship* between the defendant's crimes and the affairs of the enterprise, as "[c]onducting an enterprise that affects interstate commerce is obviously not in itself a violation of § 1962, nor is mere commission of the predicate offenses." *Sedima*, 473 U.S. at 496. In this case, however, the district court did not squarely address that relationship. It stated only that respondent had "reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status," and went on to find that "such activities fail to satisfy the degree of management required." Pet. App. A60. The gravamen of the RICO claim, however, was not that respondent reviewed and certified financial reports, but that it engaged in a pattern of mail, wire, and securities fraud in creating, and then explaining false and misleading financial statements on the Co-op's behalf. See *Plaintiffs' Responding Memorandum to the Motion of the Arthur Young Defendants for Summary Judgment*, Nos. 85-2044, 2096, 2155, & 2259 (W.D. Ark. filed Sept. 5, 1986), at 56-66. The jury later accepted that claim in finding respondent accountable for having "originated" the false or misleading statements "by which means the demand notes were sold." 18 Tr. 80 (Nov. 15, 1986) (jury

An outside adviser will often maintain an arm's-length professional relationship with a client, and the two will carry out their respective functions with a degree of independence. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984) ("‘public watchdog’ function [of accountants] demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust"). That relationship, standing alone, does not implicate RICO. If, however, an adviser compromises its independence by becoming instrumental in perpetrating illegal acts on behalf of the client, with the requisite degree of criminal intent, it may fairly be characterized as a participant in the conduct of the organization's affairs.<sup>23</sup> If the adviser's actions amount to a pattern of fraudulent conduct, the RICO statute may be applicable to that person.<sup>24</sup>

instructions with respect to claims under the federal securities laws, 15 U.S.C. 78j(b), and 17 C.F.R. 240.10b-5).

<sup>23</sup> Here, for example, petitioners contend that respondent prepared and explained fraudulent financial statements that allowed the Co-op to continue in existence for years after it had actually become insolvent. See also *Baggio v. EC Solar, Inc.*, No. 88 C-1893. 1990 U.S. Dist. LEXIS 5,569 (N.D. Ill. May 8, 1990) (accountants who prepare fraudulent tax returns for clients satisfy the "conduct or participate" element); *Bank of America v. Touche Ross & Co.*, 782 F.2d at 970 (accountants were alleged to have assisted in the preparation and dissemination of false financial statements); *In re Federal Bank & Trust Co. Securities Litigation*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565, at 98,879-98,880 (D. Ore. 1984) (accountants' role in confirming transactions in an investment program was featured in marketing literature to investors; accountants could be liable for fraudulently failing to perform that role). Likewise, lawyers who represent clients in business transactions by drafting fraudulent documents can be said to have "participate[d] in the conduct" of their client's affairs. See *Blake v. Dierdorff*, 856 F.2d 1365, 1372 (9th Cir. 1988) (attorneys were involved in allegedly fraudulent disclosures on a continuing basis and had a stake in client's success); *Odesser v. Continental Bank*, 676 F. Supp. 1305, 1312 (E.D. Pa. 1987).

<sup>24</sup> Isolated or sporadic misconduct in the course of a client engagement would not be likely to trigger RICO's application. Cf.

### C. The District Court's Entry Of Summary Judgment Rested On An Incorrect Legal Standard

Under the principles set forth above, the grant of summary judgment in favor of respondent should be vacated. Petitioners claim that respondent acted as the Co-op's auditor and intentionally created and disseminated false and misleading financial information for the Co-op, with the result that members purchased largely valueless Co-op securities. The district court held that respondent's auditing activities "fail to satisfy the degree of management [or operation] required by *Bennett v. Berg*," and dismissed the RICO claim. Pet. App. A60. The court of appeals affirmed for the same reason, stating that respondent's accounting actions, even though improper, "in no way rise to the level of participation in the management or operation of the Co-op." *Id.* at A46.

In our view, the courts below applied the wrong legal standard. Although not all action by an outside adviser to an enterprise constitutes the "conduct or participation" \* \* \* in the conduct of such enterprise's affairs," 18 U.S.C. 1962(c), it is not necessary for liability under RICO that the advisers participate (in some unexplained way) in the "management" or "operation" of the client. If an accounting firm effectively assumes the enterprise's responsibility for characterizing its transactions and creating its financial statements—and does so through a pattern of fraudulent and misleading statements that constitute "racketeering activity"—it can be held liable for

*Blake v. Dierdorff*, 856 F.2d at 1371 (accountant's conduct of a single audit held not to constitute a pattern). RICO requires that the defendant commit predicate crimes forming a "pattern." *H.J. Inc.*, 492 U.S. at 239 (pattern requires a showing that "the racketeering predicates are related, and that they amount to or pose a threat of continued criminal activity"). In addition, in order to recover damages in a private civil action under RICO, the plaintiff must establish proximate cause, which requires a showing that the plaintiff was directly injured by the alleged misconduct. *Holmes v. Securities Investor Protection Corp.*, *supra*.

"conduct[ing] or participat[ing], directly or indirectly, in the conduct of [the] enterprise's affairs."

The courts below have not had the opportunity to apply the correct legal standard to the "conduct or participate" issue in this case. Those courts, however, have gained great familiarity with the complex facts of this case in the course of prior proceedings. In light of that circumstance, and the significant development of the record since the motion for summary judgment was granted,<sup>25</sup> this case should be remanded to the court of appeals for further proceedings on the RICO claim.

### CONCLUSION

The judgment of the court of appeals should be vacated, and the case should be remanded for further proceedings.

Respectfully submitted.

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APRIL 1992

<sup>25</sup> After the RICO claim was dismissed, the case went to trial and the jury concluded that respondent had committed securities fraud, which is one of the predicate acts alleged in the RICO claim, by "originating" the false or misleading statements in the Co-op's financial reports. See note 22, *supra*.

### APPENDIX

18 U.S.C. 1962 provides:

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participation in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern o[f] racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control over of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(1a)

**2a**

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b), or (c) of this section.

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

**BOB REVES, ROBERT H. GIBBS and  
FRANCES GRAHAM, As Representatives  
of a Class of Noteholders,  
Petitioners,**

vs.

**ERNST & YOUNG,  
Respondent.**

ON WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

**BRIEF OF AMICUS CURIAE  
NATIONAL ASSOCIATION OF SECURITIES  
AND COMMERCIAL LAW ATTORNEYS  
(NASCAT) IN SUPPORT OF PETITIONERS**

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# **QUESTION PRESENTED**

Did the Eighth Circuit err when it held, in conflict with other courts of appeals, that §1962(c) of the RICO statute, which makes it "unlawful for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs through a pattern of racketeering activity," requires proof that the defendant managed or operated the enterprise?

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## INTEREST OF THE *AMICUS CURIAE*

The National Association of Securities and Commercial Law Attorneys (NASCAT) hereby files its *amicus curiae* brief in support of Petitioners. For the reasons set forth herein, NASCAT supports reversing the decision of the Eighth Circuit Court of Appeals in this case.<sup>1</sup>

NASCAT is an association of nearly 500 attorneys who litigate antitrust, commercial, consumer and securities fraud class action and derivative cases in federal and state courts throughout the country. NASCAT and its members are devoted to representing victims of corporate abuse, fraudulent schemes and so-called "white-collar" criminal activity in cases that have the potential for advancing the state of the law, educating the public, modifying corporate behavior and improving the access of victims to justice and adequate compensation for the wrongs that have been inflicted upon them.

NASCAT's members have litigated (and are presently litigating) numerous treble damage civil actions arising under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§1961-1968.<sup>2</sup> NASCAT has found

<sup>1</sup> The Eighth Circuit's decision is reported as *Arthur Young & Co. v. Reves*, 937 F.2d 1310 (8th Cir. 1991) ("*Arthur Young*"), *cert. granted and denied*, \_\_ U.S. \_\_, 60 U.S.L.W. 7578 (1992). NASCAT has obtained consent to file this brief from both Petitioners and Respondent.

<sup>2</sup> For example, members of NASCAT serve as counsel for nearly 20,000 investors in now-bankrupt American Continental Corporation ("*ACC*"), controlled by convicted felon Charles H. Keating, Jr. ("*Keating*"), who used the premises of ACC's wholly-owned, federally-insured thrift, Lincoln Savings & Loan ("*Lincoln Savings*"), to peddle hundreds of millions of dollars of junk bonds to elderly victims which became worthless when ACC declared bankruptcy and federal regulators seized Lincoln Savings in April, 1989. Keating's fraudulent scheme caused the most catastrophic savings and loan failure in American history, estimated to cost the taxpayers over \$2 billion. NASCAT's and Respondent's interests in this case and the *ACC/Lincoln Savings* case are intertwined because the victims' class action lawsuit, which is presently in trial in the District of Arizona, asserts civil RICO, federal securities fraud and state law (including Arizona RICO)

(continued)

civil RICO actions to be one of the few effective remedies that a wide range of the American people, from small businesses to the elderly, have to obtain adequate redress when they are cheated by fraudulent or criminal behavior which, unfortunately, runs rampant in today's society. To insure that the access to justice and adequate compensation which Congress expressly provided in RICO's civil remedy provisions, 18 U.S.C. §§1964-1965, based upon violations of RICO's proscriptions, 18 U.S.C. §1962, is neither narrowed nor foreclosed but, rather, is nurtured and interpreted in accordance with the statute's express remedial purpose, NASCAT believes that the decision of the court below should be reversed.

NASCAT submits that the Eighth Circuit's restrictive interpretation of the "conduct" element of §1962(c) not only misinterprets the statutory language and ignores RICO's Liberal Construction Clause and legislative history but will result in an unwarranted emasculation of the statute, which Congress expressly designed to combat organized criminal behavior and provide an additional yet essential remedy for victims of fraudulent schemes. Upholding the lower court's misguided interpretation and application of the statute in this case could result in certain professional wrongdoers'

(fn. continued)  
claims against professional co-conspirators — lawyers, accountants (including Respondent's predecessor firm, Arthur Young & Company), economists and investment bankers — who assisted Keating in operating his engine of greed and avarice. See *In re American Continental Corp./Lincoln Savings & Loan Securities Litigation*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,704 (D. Ariz. 1990). Following three days of testimony, Respondent settled investors' claims for a record payment of \$63 million while ACC/Lincoln Savings outside counsel, Jones, Day, Reavis & Pogue, paid \$24 million. See A. Cowan, *Big Law and Auditing Firms To Pay Millions in S. & L. Suit*, N.Y. Times, Mar. 31, 1992, at A1; A. Stevens, *Ernst & Young and Jones Day Law Firm To Pay \$87 Million in Lincoln S & L Case*, Wall St. J., Mar. 31, 1992, at A3. As a result, the court's decision in the case at bar, in which Respondent seeks immunity for professionals from civil and criminal RICO liability, could have immediate and lasting impact.

(including Respondent's) undeserved immunity from RICO prosecutions and treble damage civil actions. No person or entity (including accountants, attorneys, or bankers) is immune from RICO's proscriptions, yet group immunity is undeniably sought by Respondent and its fellow professional *amici* in this case. Moreover, failure to reverse the decision of the court below would unduly hamper the Government's ability to rely on §1962(c) in criminal RICO prosecutions, where it has been effectively utilized in organized crime cases over the past 20 years.

## ARGUMENT

### A. RICO'S EXPRESS STATUTORY LANGUAGE, MANDATED LIBERAL CONSTRUCTION AND LEGISLATIVE HISTORY REQUIRES THIS COURT TO INTERPRET SECTION 1962(c) BROADLY TO EFFECTUATE THE STATUTE'S REMEDIAL PURPOSES

This civil RICO case focuses on the proper interpretation of the "conduct" element of §1962(c) of the statute.<sup>3</sup> Contrary to Respondent's assertion, §1962(c)'s purposeful disjunctive construction makes unlawful the direct *or* indirect conduct of *or* participation in the conduct of an enterprise's affairs by *any* person employed by *or* associated with the enterprise.<sup>4</sup> The broad statutory language deliberately employed by Congress in crafting RICO<sup>5</sup> and especially

<sup>3</sup> RICO makes it "unlawful for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity . . ." 18 U.S.C. §1962(c).

<sup>4</sup> See *H.J., Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229, 231-32 (1989) ("RICO renders criminally and civilly liable 'any person' . . . who, being employed by or associated with . . . an enterprise, conducts or participates in the conduct of its affairs 'through a pattern of racketeering activity'"); see also *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 496 (1985) ("A violation of §1962(c) . . . requires (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity.") (footnote omitted).

§1962(c)<sup>6</sup> does not distinguish between so-called "insider" and "outsider" defendants<sup>7</sup> in criminal or civil cases; rather,

<sup>5</sup> RICO, Chapter 96 of Title 18 of the U.S. Code, 18 U.S.C. §§1961-1968, was added by Title IX of the Organized Crime Control Act of 1970 ("OCCA"), Pub. L. 91-452, 84 Stat. 941. Section 904(a) of OCCA, 84 Stat. 947, directs that "[t]he provisions of this Title shall be liberally construed to effectuate its remedial purposes." As stated in *Russello v. United States*, 464 U.S. 16, 27 (1983), RICO is the "only substantive federal criminal statute that contains such a directive," and as elaborated in *Sedima*, a civil RICO case:

This less restrictive reading [of RICO] is amply supported by our prior cases and the general principles surrounding this statute. RICO is to be read broadly. This is the lesson not only of Congress' self-consciously expansive language, see *United States v. Turkette*, 452 U.S. 576, 586-587 (1981), but also of its express admonition that RICO is to "be liberally construed to effectuate its remedial purposes," Pub. L. 91-452, §904(a), 84 Stat. 947. The statute's "remedial purposes" are nowhere more evident than in the provision of a private action for those injured by racketeering activity.

473 U.S. at 497-98. In *Sedima*, this Court also stated that "if Congress' liberal-construction mandate is to be applied anywhere, it is in §1964, where RICO's remedial purposes are most evident." *Id.* at 491 n.10. RICO's Liberal Construction Clause is used to interpret the statute in both civil and criminal cases, see *Tafflin v. Levitt*, 493 U.S. 455, 467 (1990); *Northwestern Bell*, 492 U.S. at 248-49; *United States v. Monsanto*, 491 U.S. 600, 609 (1989); *Russello*, 464 U.S. at 21; *United States v. Turkette*, 452 U.S. 576, 587, 593 (1981). Notwithstanding Respondent's urgings, it cannot be avoided here.

<sup>6</sup> The House and Senate Reports accompanying RICO expressly stated that §1962(c)'s prohibitions are without limitation or exception. See Organized Crime Control Act of 1969, S. Rep. No. 617, 91st Cong., 1st Sess. 159 (1969) (§1962(c) applies to any "conduct of the enterprise through the prohibited pattern"; "there is no limitation on the prohibition"); H.R. Rep. No. 1549, 91st Cong., 2d Sess. 4033 (1970) (same). See also *Russello*, 464 U.S. at 21-22 (calling "participate" and other RICO definitions "concepts of breadth"); *Haroco, Inc. v. American Nat'l Bank & Trust Co.*, 747 F.2d 384, 398 (7th Cir. 1984) ("conduct" and "participate" are "broad terms which would defy judicial confinement"), *aff'd on other grounds per curiam*, 473 U.S. 606 (1985).

<sup>7</sup> Persons or entities "employed by" the enterprise are often referred to as "insiders" while "outsiders" are most often held liable under §1962(c)'s  
(continued)

any person "associated with" the enterprise who directly or indirectly participates in the "conduct" of its affairs through a pattern of racketeering activity has violated the statute.<sup>8</sup>

The court below inexplicably ignored §1962(c)'s deliberately broad and disjunctive construction, as well as RICO's express legislative history, when it held that Respondent did not directly or indirectly conduct or participate in the conduct of the enterprise's affairs.<sup>9</sup>

(fn. continued)

"associated with" language, see *United States v. Garver*, 809 F.2d 1291, 1301 (7th Cir. 1987); however, professional assistants such as Respondent who are employed or retained to assist in a fraudulent scheme may face liability under either clause because of their necessarily intimate involvement with kingpins like Milken and Keating.

<sup>8</sup> See *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union* 639, 913 F.2d 948, 954 (D.C. Cir. 1990) (en banc) ("[§]1962(c) provides that participation may be indirect as well as direct, and nothing . . . precludes liability on the part of outsiders. The crucial question is not whether a person is an insider or an outsider . . ."), *cert. denied*, \_\_\_ U.S. \_\_\_, 111 S. Ct. 2839 (1991); *Garver*, 809 F.2d at 1301 (quoting *United States v. Elliott*, 571 F.2d 880, 903 (5th Cir.), *cert. denied*, 439 U.S. 953 (1978)) (RICO applies to both insiders and outsiders — "those merely 'associated with' an enterprise — who participate . . . in the enterprise's affairs . . .").

<sup>9</sup> This case is a class action arising out of the sale of securities (notes) issued by a cooperative. Summary judgment was granted by the district court as to the RICO claim against the outside auditor (Arthur Young) and was affirmed by the Eighth Circuit, which held that the auditor's involvement in the enterprise (the cooperative) "did not rise to the level required for a RICO violation." *Arthur Young*, 937 F.2d at 1324. The Eighth Circuit stated that participating in the conduct of the affairs of an enterprise in violation of §1962(c) "ordinarily will require some form of participation in [its] operation or management," and held that Respondent's performance of audits, meeting with the board of directors to explain the audits, and making presentations at annual meetings "in no way rise[s] to the level of participation in the management or operation of" the cooperative, even though "[i]n the course of this involvement it is clear that Arthur Young committed a number of reprehensible acts." *Id.* In so holding, the court ignored RICO's statutory language, mandated liberal construction and legislative history, as well as its previous interpretation of the "conduct" element in criminal RICO cases and its construction of the identical term found in another provision of OCCA, the federal gambling syndicate  
(continued)

To find the meaning of "conduct," this Court must "begin, of course, with RICO's text, in which Congress followed a 'pattern [of] utilizing terms and concepts of breadth' "<sup>10</sup> and must " 'start with the assumption that the legislative purpose is expressed by the ordinary meaning of the words used.' "<sup>11</sup> If RICO's language is plain, it controls;<sup>12</sup> if its language, syntax, or context is ambiguous,<sup>13</sup> the construction that

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statute, 18 U.S.C. §1955. Thus, the Eighth Circuit not only reached the wrong result, but its method of analysis was seriously flawed.

<sup>10</sup> *Northwestern Bell*, 492 U.S. at 237 (quoting *Russello*, 464 U.S. at 21).

<sup>11</sup> *Id.* at 238 (quoting *Richards v. United States*, 369 U.S. 1, 9 (1962)).

<sup>12</sup> *Id.* at 249; see also *Monsanto*, 491 U.S. at 606; *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 229 (1987); *Russello*, 464 U.S. at 21, 29; *Turkette*, 452 U.S. at 587 n.10.

<sup>13</sup> In *Northwestern Bell*, where this Court reversed the Eighth Circuit's restrictive interpretation of "pattern of racketeering activity," Justice Brennan began the Court's analysis by construing RICO's statutory text, 492 U.S. at 237-39, relying on a dictionary definition of "pattern" to find its "normal usage," *id.* at 238 ("A 'pattern' is an 'arrangement or order of things or activities.' ") (quoting 11 *Oxford English Dictionary* 357 (2d ed. 1989)). In this case, the court below cited with favor the District of Columbia Circuit's earlier decision in *Yellow Bus*, which had also adopted a restrictive interpretation of "conduct" and offered the following linguistic analysis:

"Conduct" is synonymous with "management" or "direction." Webster's Third New International Dictionary 473 (1961). The "conduct of the [enterprise's] affairs" thus connotes more than just some relationship to the enterprise's activity; the phrase refers to the guidance, management, direction or other exercise of control over the course of the enterprise's activities. In order to participate in the conduct of an enterprise's affairs, then, a person must participate, to some extent, in "running the show."

*Yellow Bus*, 913 F.2d at 954; see *Arthur Young*, 937 F.2d at 1324. But these courts' purported "plain language" analysis is far too restrictive because it is generally recognized that persons who take part in carrying out the activities of an enterprise without managing or directing its goals still "conduct" its activities. Thus, the definition of "conduct" found in 3 *Oxford English Dictionary* 691 (2d ed. 1989), the same dictionary utilized by this Court in *Northwestern Bell*, 492 U.S. at 238, includes the meaning

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would "effectuate its remedial purposes" by "providing enhanced sanctions and new remedies" must be adopted,<sup>14</sup> and for more specific guidance, this Court "must look past the [statutory] text to RICO's legislative history, as we have done in prior cases construing the Act."<sup>15</sup> Finally, as the court below pointedly ignored in this case, "conduct" must be read in the same fashion, whether civil<sup>16</sup> or criminal! RICO is involved.<sup>17</sup> When these rules of construction are

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"[t]o direct, manage, carry on (a transaction, process, business, institution, legal case, etc.)," but pointedly adds: "The notion of direction or leadership is often obscured or lost; e.g., an investigation is *conducted* by all those who take part in it." To the same effect is *Webster's Dictionary of Synonyms* 184 (1942) (emphasis added), which states that "[c]onduct may imply the act of an agent who is both the leader and the person responsible for the acts and achievements of a group having a common end or goal . . . , but often the idea of leadership is lost or obscured, and the stress is placed on a carrying on by all or by many of the participants." Giving RICO's terms their "ordinary meaning," *Russello*, 464 U.S. at 21, the term "conduct" does not include these misguided courts' limitation that a person must participate in "running the show." Indeed, imposing a "management" or "significant control" limitation on the term "conduct" violates this Court's rule of RICO construction because it reads words into the statute that "appear[] nowhere in the language or legislative history." *Id.* at 240-41 (rejecting Eighth Circuit's "multiple scheme" limitation on "pattern" requirement because of lack of support in the statute or legislative history).

<sup>14</sup> 84 Stat. at 947; see also *Tafflin*, 493 U.S. at 466-67; *Monsanto*, 491 U.S. at 609; *Sedima*, 473 U.S. at 497-98; *Russello*, 464 U.S. at 27; *Turkette*, 452 U.S. at 587-88, 593.

<sup>15</sup> *Northwestern Bell*, 492 U.S. at 229 (citing *Sedima*, 473 U.S. at 486-90; *Russello*, 464 U.S. at 26-29; and *Turkette*, 452 U.S. at 586-87).

<sup>16</sup> Violations of RICO may be enforced by private treble damage suits brought under §1964(c), which provides that "[a]ny person injured in his business or property by reason of" a violation of §1962 may sue. 18 U.S.C. §1964(c). Thus, the statute brings to bear "the pressure of 'private attorneys general' on a serious national problem for which private prosecutorial resources are deemed inadequate." *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 151 (1987); see also *Holmes v. SIPC*, \_\_\_ U.S. \_\_\_, 1992 U.S. LEXIS 1947, at \*44 (Mar. 24, 1992) (O'Connor, J., and White and Scalia, JJ., concurring in part).

followed, the untenability of the Eighth Circuit's decision becomes clear.

**B. THE STANDARD ADOPTED BY THE COURT BELOW IS CONTRARY TO THAT FOLLOWED IN OTHER CIRCUITS AND CONFLICTS WITH RICO'S STATED PURPOSE TO PROTECT LEGITIMATE BUSINESS AGAINST INFILTRATION AT ALL LEVELS**

In considering the meaning of "conduct," most circuit courts have properly adopted varying formulations of the same general approach: they require *some* relationship between the affairs of the enterprise and a defendant's predicate acts of racketeering, but recognize that a mere coincidental or tangential connection between a person, a legitimate enterprise, and the racketeering activity is not sufficient. Yet, most courts recognize that "conduct" must be interpreted and applied in the broadest possible manner to insure that the statute's express purpose to combat<sup>18</sup> organ-

<sup>17</sup> *Shearson*, 482 U.S. at 239; *Sedima*, 473 U.S. at 489; cf. *Northern Sec. Co. v. United States*, 193 U.S. 197, 401 (1904) (Holmes, J., dissenting) ("The words [used in a statute] cannot be read one way in a suit which is to end in a fine and imprisonment and another way in one which seeks an injunction.").

<sup>18</sup> Congress enacted RICO as Title IX of OCCA because it found that 18th and 19th Century jurisprudence was ineffective to combat white-collar crime and fraudulent behavior. OCCA's Statement of Findings recognized that organized crime "is a highly sophisticated, diversified, and widespread activity that annually drains billions of dollars from America's economy by unlawful conduct and the illegal use of force, *fraud*, and corruption," that such activities "weaken the stability of the Nation's economic system, *harm innocent investors and competing organizations*, interfere with free competition, seriously burden interstate and foreign commerce, threaten the domestic security, and undermine the general welfare of the Nation and its citizens" and that organized crime "continues to grow" because "the sanctions and remedies available to the Government are necessarily limited in scope and impact." In light of these findings, it was Congress' declared purpose "to seek the eradication of organized crime" by "providing *enhanced sanctions and new remedies* to deal with" its unlawful activities. 84 Stat. 922-23 (emphasis added); see also *Turkette*, 452 U.S. at 588-89

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ized crime,<sup>19</sup> fraud and so-called "white-collar" crime<sup>20</sup> will not be frustrated.<sup>21</sup>

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(quoting Statement of Findings).

<sup>19</sup> RICO's legislative history "clearly demonstrates that . . . [it] was intended to provide new weapons of unprecedented scope for an assault upon organized crime and its economic roots." *Russello*, 464 U.S. at 26. Although the major purpose of Title IX was "to address the infiltration of legitimate business by organized crime," *Turkette*, 452 U.S. at 591, RICO was *not* limited to the prohibition of infiltration of legitimate organizations. *Id.* at 590. Nor does RICO apply only to organized crime in the classic "mobster" sense. *Sedima*, 473 U.S. at 495 ("not just mobsters"). Just three years ago, this Court rejected a full-court press from various *amici* aligned with the accounting profession, finding that their arguments for reading an organized crime limitation into RICO's "pattern" element "finds no support in the Act's text, and is at odds with the tenor of its legislative history." *Northwestern Bell*, 492 U.S. at 244. Rather, §1961(1) of RICO, with its purposefully broad definition of "racketeering activity," acknowledges the "breakdown of the traditional conception of organized crime, and responds to a new situation in which persons engaged in long-term criminal activity often operate *wholly* within legitimate enterprises." *Id.* at 248 (emphasis in original). Congress drafted the statute "broadly enough to encompass a wide range of criminal activity, taking many different forms and likely to attract a broad array of perpetrators operating in many different ways." *Id.* at 248-49.

<sup>20</sup> The Chief Justice has stated that "[w]hite collar crime is 'the most serious and all-pervasive crime problem in America today.'" *Braswell v. United States*, 487 U.S. 99, 115 n.9 (1988) (quoting Conyers, *Corporate and White-Collar Crime: A View by the Chairman of the House Subcommittee on Crime*, 17 Am. Crim. L. Rev. 287, 288 (1980)). The Chief Justice added, "[a]lthough this statement was made [by Rep. Conyers] in 1980, there is no reason to think the problem has diminished in the meantime." *Id.* While RICO may have been primarily aimed at "organized crime," its use "as a weapon against 'white collar crime' . . . is not contrary to the intent of Congress but is in fact one of the 'benefits' Congress saw the Act as providing." *Papai v. Cremosnik*, 635 F. Supp. 1402, 1411 (N.D. Ill. 1986) (citation omitted). See also *Furman v. Cirrito*, 741 F.2d 524, 529 (2d Cir. 1984), *vacated in part on other grounds sub nom., Joel v. Cirrito*, 473 U.S. 922 (1985).

<sup>21</sup> Congress would hardly have made it unlawful to "conduct" or "participate directly or indirectly in the conduct of" the enterprise's affairs, 18 U.S.C. §1962(c) (emphasis added), if it had wanted to impose a narrow

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The narrow standard adopted by the court below, however, directly contravenes RICO's stated purpose to protect legitimate business against infiltration at all levels<sup>22</sup> and it stands in marked conflict with the correct standard adopted in other circuits — including the Eighth Circuit — in civil *and* criminal RICO cases. Indeed, NASCAT submits that affirming the decision in this case would severely limit RICO's effectiveness as a prosecutorial tool in the Government's ongoing (and increasingly effective) war against organized crime, and would seriously endanger RICO's use as a weapon to combat consumer and investment fraud.

Reference to numerous cases demonstrates §1962(c)'s utility in such essential criminal and civil prosecutions. For

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rule reaching only those who had obtained some significant level of control over the management or operation of the enterprise. Indeed, Congress is quite familiar with language that restricts a statute's reach to the leaders or managers of an enterprise. See 21 U.S.C. §848(b) (prescribing penalties for "[a]ny person who engages in a continuing criminal enterprise . . . if — (1) such person is the principal administrator, organizer, or leader of the enterprise or is one of several such principal administrators, organizers, or leaders"); see *Garrett v. United States*, 471 U.S. 773, 781 (1985) (noting that §848 contains "a carefully crafted prohibition aimed at a special problem. This language is designed to reach the 'top brass' in the drug rings, not the lieutenants and foot soldiers."). If Congress had intended to limit the class of persons or entities which could be found to directly or indirectly "conduct" the affairs of an enterprise, narrowing the definition of the word in question was all it took to achieve that objective. See *Turkette*, 452 U.S. at 581 (discussing statutory definition of "enterprise" and observing that Congress could have "narrowed the sweep of the definition by inserting a single word").

<sup>22</sup> RICO's foremost purpose was to eliminate the "infiltration of organized crime and racketeering into legitimate organizations," S. Rep. No. 617, 91st Cong., 1st Sess. at 76. Such "infiltration" can take place gradually, and perniciously, long before it reaches the corporate boardroom or management suite. Accordingly, because "the RICO net is woven tightly to trap even the smallest fish, those peripherally involved with the enterprise," *United States v. Elliott*, 571 F.2d at 903, a "conduct" test limited to those who exercise significant control over the enterprise, manage it, or direct its activities cannot be reconciled with RICO's express objectives.

example, in *United States v. Scotto*,<sup>23</sup> which involved the receipt of illegal kickbacks by Anthony Scotto, the president of Local 1814 of the International Longshoremen's Association ("ILA"), the RICO enterprise, and Anthony Anastasio, the Local's executive vice president, the Second Circuit rejected defendants' argument on appeal that the trial court erred in refusing to instruct the jury that it must find that their predicate acts "concerned or related to the operation or management of the enterprise" and " '[a]ffected [its] affairs . . . in its essential functions.' "<sup>24</sup> In a landmark decision, the Second Circuit fashioned RICO's "conduct" test in the broadest possible terms:

We think that one conducts the affairs of an enterprise through a pattern of racketeering activity when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, *or* (2) the predicate offenses are related to the activities of that enterprise. Simply committing predicate acts which are unrelated to the enterprise or one's position within it would be insufficient.<sup>25</sup>

<sup>23</sup> 641 F.2d 47 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981).

<sup>24</sup> *Id.* at 54 & n.3.

<sup>25</sup> *Id.* at 54 (emphasis added). The *Scotto* court further clarified and emphasized the broadness of the test adopted:

"Section 1962(c) nowhere requires proof regarding the advancement of the union's affairs by the defendant's activities, or proof that the union itself is corrupt, or proof that the union authorized the defendant to do whatever acts form the basis for the charge. It requires only that the government establish that the defendant's acts were committed in the conduct of the union's affairs."

641 F.2d at 54 (quoting *United States v. Field*, 432 F. Supp. 55 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1371 (2d Cir.), *cert. dismissed*, 439 U.S. 801 (1978)). The Second Circuit has consistently followed *Scotto* in both criminal RICO, see, e.g., *United States v. Simmons*, 923 F.2d 934, 951 (2d Cir.) (collecting cases), *cert. denied*, \_\_\_ U.S. \_\_\_, 111 S. Ct. 2018 (1991);

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The Second Circuit's formulation of the "conduct" element<sup>26</sup> has been followed in the Third Circuit<sup>27</sup> and Ninth Circuit,<sup>28</sup> and with certain modifications it is generally

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*United States v. Robilotto*, 828 F.2d 940, 947-48 (2d Cir. 1987) (personal loans received by a union official because of his status were sufficiently related to the enterprise), *cert. denied*, 484 U.S. 1011 (1988); *United States v. LeRoy*, 687 F.2d 610, 617 (2d Cir. 1982) (illegal kickbacks received by union official because of his status were sufficiently related to the enterprise), *cert. denied*, 459 U.S. 1174 (1983), and civil RICO cases, *see, e.g., Farberware, Inc. v. Groben*, 764 F. Supp. 296, 307 (S.D.N.Y. 1991).

<sup>26</sup> In cases involving accountants and other professional defendants, however, certain district courts have improperly adopted a more stringent standard and exonerated such wrongdoers from RICO liability, often without citing, much less distinguishing, *Scotto*, and ignoring §1962(c)'s express language and legislative history. *See, e.g., Morin v. Trupin*, 747 F. Supp. 1051, 1066 (S.D.N.Y. 1990) (requiring plaintiff to plead and demonstrate "a factual basis for regarding the relationship between particular defendants (such as the appraisers, accountants, and lawyers) and the enterprise to be different than the typical contractual relationship between client and professional"). Given these cases' failure to adhere to the *Scotto* standard, Respondent's reliance upon them is misplaced. *See National Union Fire Ins. Co. v. Calinvest*, No. 90 Civ. 2476 (LLS), 1992 U.S. Dist. LEXIS 1956, at \*22-23 (S.D.N.Y. Feb. 14, 1992).

<sup>27</sup> In *United States v. Provenzano*, 688 F.2d 194 (3d Cir.), *cert. denied*, 459 U.S. 1071 (1982), which affirmed a union official's conviction for accepting bribes in exchange for allowing violations of the collective bargaining unit, the RICO enterprise was the union local and the Third Circuit stated that "[t]he fact that the union was harmed rather than benefitted does not remove the conduct from RICO's ambit. . . . It is only when the predicate acts are unrelated to the enterprise or the actor's association with it that the nexus element is missing, and consequently there is no RICO violation." 688 F.2d at 200; *see also United States v. Zaubers*, 857 F.2d 137, 150 (3d Cir. 1988) (RICO conspiracy conviction for kickback scheme in connection with pension fund loan affirmed where enterprise was recipient of the loans; making a loan to the corporation constitutes participating in the conduct of its affairs), *cert. denied*, 489 U.S. 1066 (1989); *United States v. Palmeri*, 630 F.2d 192, 199 n.3 (3d Cir. 1980) ("If two or more violations of §1954 are established, the defendant becomes subject to §1962(c), which requires that these two 'acts of racketeering' be related to the conduct of the enterprise.") (citation omitted), *cert. denied*, 450 U.S. 967 (1981).

<sup>28</sup> *See, e.g., United States v. Yarbrough*, 852 F.2d 1522, 1544 (9th Cir.) (continued)

followed in the Fifth, Sixth and Seventh Circuits;<sup>29</sup> the state of the law in other circuits, however, is more confusing,

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(affirming RICO conviction for participation in right wing supremacy group and stating that "[t]he Ninth Circuit has adopted the *Scotto* test," i.e., it is enough that the predicate acts have some relationship to the enterprise), *cert. denied*, 488 U.S. 866 (1988); *Sun Savs. & Loan Ass'n v. Dierdorff*, 825 F.2d 187, 195 (9th Cir. 1987) (thrift institution alleged requisite nexus between its former president's racketeering activity and its affairs: "When he committed the alleged predicate acts of mail fraud, Dierdorff acted in his capacity as Sun's president. The acts of mail fraud were all related to the activities of Sun. Therefore, the complaint adequately alleges that Dierdorff conducted or participated in the conduct of Sun's affairs through a pattern of racketeering activity."); *see also Blake v. Dierdorff*, 856 F.2d 1365, 1372 (9th Cir. 1988).

<sup>29</sup> The Fifth Circuit originally adopted the *Scotto* approach, stating that §1962(c) merely required some "relation between the predicate offenses and the affairs of the enterprise." *United States v. Welch*, 656 F.2d 1039, 1061 (5th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982). In *United States v. Cauble*, 706 F.2d 1322 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984), however, the court slightly modified the *Scotto* test, stating that:

A defendant does not "conduct" or "participate in the conduct" of a lawful enterprise's affairs, unless (1) the defendant has in fact committed the racketeering acts as alleged; (2) the defendant's position in the enterprise facilitated his commission of the racketeering acts; and (3) the predicate acts had some effect on the lawful enterprise.

706 F.2d at 1332-33 (emphasis added). The Fifth Circuit noted that its test cannot be met where a defendant simply "works for a legitimate enterprise and commits racketeering acts while on he business premises"; nor does "a defendant's mere association with a lawful enterprise whose affairs are conducted through a pattern of racketeering activity in which he is not personally engaged" violate RICO. *Id.* at 1332. The *Cauble* court stated that establishing an "effect" on the enterprise is not a stringent requirement; it can be satisfied, for example, by the defendant's depositing of funds in the enterprise's bank accounts, *id.* at 1332 n.24, and the court there affirmed a §1962(c) conviction where the defendant used assets and capital of his partnership — the RICO enterprise — to aid and abet drug smuggling activities. *Id.* at 1341.

In addition to the Sixth Circuit, *see United States v. Qaoud*, 777 F.2d 1105, 1115 (6th Cir. 1985), *cert. denied*, 475 U.S. 1098 (1986), *Cauble* has been followed in the Seventh Circuit, *see Overnite Transp. Co. v. Truck Drivers, Etc. Local No. 705*, 904 F.2d 391, 393-94 (7th Cir. 1990); *United* (continued)

including the inexplicably inconsistent standard followed in the Eighth Circuit.<sup>30</sup>

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*States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988), and *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987), and in criminal RICO cases that court has always interpreted "conduct" broadly.

<sup>30</sup> In *Bennett v. Berg*, 685 F.2d 1053 (8th Cir.), *aff'd en banc*, 710 F.2d 1361 (8th Cir.), *cert. denied*, 464 U.S. 1008 (1983), over 2,500 present and former residents of a retirement community brought a civil RICO action alleging that it had been subject to financial mismanagement and self-dealing such that they were in danger of losing "life-care" which they were promised and naming as defendants the project's mortgage lender (Prudential), accountants (SG&M) and attorneys. Affirming in part and reversing in part the district court's dismissal of the RICO claims, a panel of the Eighth Circuit rejected certain defendants' contention that they did not fall within §1962(c)'s proscriptions, stating that "[t]hese defendants were the mortgage lender and accountant to the Village. They were 'associated with' an enterprise." 685 F.2d at 1063 n.16. Sitting *en banc*, the Eighth Circuit expressed concern that plaintiffs' complaint "may be deficient in failing to allege adequately the requisite *degree* of participation in or conduct of the affairs of an enterprise on the part of each named defendant," 710 F.2d at 1364 (emphasis in original), and suggested in dictum:

Mere participation in the predicate offenses listed in RICO, even in conjunction with a RICO enterprise, may be insufficient to support a RICO cause of action. A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself.

*Id.* On remand, however, Judge Roberts denied Prudential's and SG&M's motion to dismiss and held that the amended complaint sufficiently alleged their participation in the enterprise:

I do not believe the words "conduct or participate, directly or indirectly, in the conduct of the enterprise's affairs" can reasonably be limited to the sort of "hands-on-management" of daily activities which Prudential and SG&M suggest. I find no case authority supporting such a proposition; and to require that degree of involvement would both seem counter to the broad Congressional directive that "[t]he provisions of RICO shall be liberally construed to effectuate its remedial purposes," and incompatible with the express language of the statute, which provides that such conduct or participation in the affairs of the enterprise may be accomplished "directly or indirectly."

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Courts have almost uniformly reasoned that criminal (or fraudulent) activity far below the level of senior management can yield significant profits to wrongdoers and thwart the attainment of the enterprise's legitimate goals. Thus, "outsiders" who assist an enterprise to commit crimes, use its resources for criminal purposes, or influence its actions surely "participate . . . in the conduct of its affairs" through the prohibited pattern in violation of §1962(c), even though not significantly controlling its overall goals<sup>31</sup> and in affirming RICO convictions the courts have consistently (and correctly) construed the statute to reach that sort of misconduct. For example, in *United States v. Yonan*, 800 F.2d 164 (7th Cir. 1986), *cert. denied*, 479 U.S. 1055 (1987), the Seventh Circuit held that a criminal defense attorney who attempted to bribe a prosecutor to influence the disposition

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*Bennett v. Berg*, Civil Action No. 80-0381-CV-W, 1984 Westlaw 2756 (W.D. Mo. June 21, 1984) (quoting Pub. L. 91-452, §904(a), 84 Stat. 947; other citations omitted). In this case, the Eighth Circuit improperly relied upon dictum from its *en banc* opinion in *Bennett*, 710 F.2d at 1364, and ignored the district court's subsequent (and proper) interpretation of that ruling. See *Arthur Young*, 937 F.2d at 1324.

Moreover, the court below ignored *United States v. Ellison*, 793 F.2d 942 (8th Cir.), *cert. denied*, 479 U.S. 937 (1986), where the Eighth Circuit did *not* cite its earlier decision in *Bennett*, 710 F.2d at 1364; instead, it endorsed the Fifth Circuit's *Cauble* standard and affirmed the conviction of the leader of a white supremacy group over the challenge that one of the arsons proved as part of the pattern of racketeering activity did not involve conduct of the affairs of that group. 793 F.2d at 950. The Eighth Circuit stated that "[t]he government did not have to prove that Ellison's racketeering activity benefitted the enterprise, but only that the predicate acts affected the enterprise." *Id.* (emphasis in original) (citing *Cauble*, 706 F.2d at 1333 n.24).

<sup>31</sup> See *United States v. Stofsky*, 409 F. Supp. 609, 613 (S.D.N.Y. 1973) ("The perversion of legitimate business may take many forms. The goals of the enterprise may themselves be subverted. Or the legitimate goals may be continued as a front for unrelated criminal activity. Or the criminal activity may be pursued by some persons in direct conflict with the legitimate goals, pursued by others. Or the criminal activity may, indeed, be utilized to fulfill otherwise legitimate goals.")

of cases participated in the "conduct" of the affairs of the State's Attorney's Office:

[T]here is no statutory requirement that such persons have contact with policymakers or heads of enterprises before they can be said to be associated with it. In the absence of a statutory definition of "association," the cases have adopted a common sense reading of the term that focuses on the business of the enterprise and the relationship of the defendant to that business. The cases make clear that the defendant need not have a stake in the enterprise's "goals," but can associate with the enterprise by conducting business with it, even if in doing so the defendant is *subverting* the enterprise's goals.<sup>32</sup>

Criminal RICO cases unanimously support this mandated liberal interpretation of §1962(c)<sup>33</sup> and, as noted above,

<sup>32</sup> 800 F.2d at 167 (emphasis in original). As the Seventh Circuit applied its test to the facts of the case before it:

Here, the defendant is clearly alleged to have a business relationship with the enterprise. The relevant business of the Cook County State's Attorney's Office is to prosecute and otherwise dispose of criminal cases; Yonan's business as an attorney was to negotiate with, oppose, or otherwise deal with that office in representing criminal defendants. This alleged relationship is sufficient for the court to find that Yonan was associated with the State's Attorney's Office for purposes of [§]1962(c).

800 F.2d at 168; accord *United States v. Mokol*, No. 90-2681, 1992 U.S. App. LEXIS 4728 (7th Cir. Mar. 18, 1992) (chief deputy sheriff who accepted bribes in exchange for protecting illegal video poker operation was "associated with" amusement company/RICO enterprise).

<sup>33</sup> See, e.g., *United States v. Kaplan*, 886 F.2d 536, 540-41 (2d Cir. 1989) (bribery of Parking Violations Bureau officials in return for contracts constituted "conduct" of bureau's affairs), *cert. denied*, 493 U.S. 1076 (1990); *United States v. Roth*, 860 F.2d 1382, 1390 (7th Cir. 1988) (lawyer who bribed Cook County Circuit Court judges participated in the conduct of the court's affairs), *cert. denied*, 490 U.S. 1080 (1989); *Horak*, 833 F.2d at 1239 (employee of corporate subsidiary participated in the conduct of the

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there is no reasoned basis why RICO should be read or applied differently in its civil context; thus similar principles have been uniformly applied in treble damage actions arising under §1964(c).<sup>34</sup> In its seminal civil RICO decision in *Schacht v. Brown*,<sup>35</sup> the Seventh Circuit posited the applicable rule in the following broad terms:

"The nature of racketeering connections to an otherwise legitimate business suggests that elements outside a company may assist in obtaining

(fn. continued)  
parent company's affairs by fraudulently procuring contracts for the subsidiary which financially benefitted the parent company: " 'conduct' in [§]1962(c) does not mean 'control' or 'manage,' and, in any event, [§]1962(c) also proscribes 'participat[ion], directly or indirectly, in the conduct' of the affairs of the enterprise"); *United States v. De Peri*, 778 F.2d 963, 983 (3d Cir. 1985) (§1962(c) "draws no distinction between the foot soldier and the general"), *cert. denied*, 475 U.S. 1110 (1986); *United States v. Watchmaker*, 761 F.2d 1459, 1476 (11th Cir. 1985) (RICO conviction affirmed where defendant's only involvement in the enterprise — a motorcycle club engaged in prostitution and drug distribution — was a single incident in which he shot three people; even those persons peripherally involved in the enterprise may be held liable because "the RICO statute was not designed to apply only to the 'kingpins' of criminal enterprises"), *cert. denied*, 474 U.S. 1100 (1986); *United States v. Janotti*, 729 F.2d 213, 226-27 (3d Cir.) (city councilman participated in the conduct of a law firm's affairs by accepting bribe to facilitate approval of a transaction from which the law firm stood to benefit by representing the bribe payer), *cert. denied*, 469 U.S. 880 (1984); *United States v. Bright*, 630 F.2d 804, 830-31 (5th Cir. 1980) (bonding company paying kickbacks to sheriff's office in return for business is sufficiently "associated with" that office).

<sup>34</sup> See, e.g., *Town of Kearny v. Hudson Meadows Urban Renewal Corp.*, 829 F.2d 1263, 1269 (3d Cir. 1987) ("A party is not shielded from RICO liability merely because he was not one of the creators or prime movers of the enterprise. Participation in the enterprise, if substantial, as Jerry Turco's participation could be found to be, is enough to establish liability, regardless of whether the timing of such substantial participation postdates the commencement of the enterprise. Both the captains and the lately enlisted foot soldiers in the enterprise are liable for the damage caused by their predicate acts.") (citation omitted).

<sup>35</sup> 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

the company's illegal goals. Thus, '[t]he substantive provisions of the RICO statute apply to insiders *and outsiders* — those merely "associated with" an enterprise — who participate directly *and indirectly* in the enterprise's affairs through a pattern of racketeering activity. Thus, the RICO net is woven tightly to trap even the smallest fish, those peripherally involved with the enterprise.'<sup>36</sup>

In *Schacht*, the Director of Insurance of the State of Illinois (Director) in its role as statutory liquidator of an insolvent insurer (Reserve), brought a civil RICO action against the officers, directors and parent corporation (ARC) who allegedly continued Reserve in business past the point of insolvency and looted it of its most profitable and least risky business by entering into long-term contracts with other insurers. The Director also sued three accounting firms (Coopers & Lybrand, Alexander Grant & Company and Arthur Andersen & Company), alleging that they knew of Reserve's insolvency and of the further impairing effect of Reserve's continued operations but that, despite this knowledge, each of them prepared unqualified opinion letters as to ARC's consolidated financial statements in 1974, 1975, 1976 and 1977.<sup>37</sup>

<sup>36</sup> 711 F.2d at 1360 (emphasis in original) (quoting *United States v. Starnes*, 644 F.2d 673, 679 (7th Cir. 1981), and *Elliott*, 571 F.2d at 903); see also *United States v. Tille*, 729 F.2d 615, 620 (9th Cir.) ("Proof of defendant's association with the illegal activities of the enterprise is all that is required. Associated outsiders who participate in a racketeering enterprise's affairs fall within RICO's strictures.") (citations omitted), *cert. denied*, 469 U.S. 845 (1984).

<sup>37</sup> 711 F.2d at 1345. In essence, the Director alleged that the accounting firm defendants joined with ARC and Reserve's officers and directors in a "multifaceted, fraudulent scheme" which kept Reserve operating long past insolvency and in a manner which resulted in enormous loans to the latter company. *Id.* at 1345-46.

Affirming the denial of defendants' motions to dismiss, the Seventh Circuit specifically rejected their argument that §1962(c) requires that they must be an "insider" or "manager" of the damage-causing RICO enterprise in order to suffer liability. Stating that "[w]e do not believe that the language and purpose of §1962(c) supports such an interpretation," and noting that "[o]ther courts . . . have had little trouble in finding that defendants who are not managers or employees in the colloquial sense are nevertheless reached by §1962(c),"<sup>38</sup> the *Schacht* court concluded that the defendant insurance companies, "who allegedly entered into long-term contracts with ARC," and the defendant auditors, "who allegedly aided the managerial defendants in operating ARC through systematic fraud" are sufficiently "associated with" or "employed by" ARC "within the meaning of" §1962(c).<sup>39</sup>

Thus, the rule adopted by the court below conflicts with better-reasoned civil *and* criminal RICO cases and, should it be allowed to stand, will undoubtedly limit RICO's utility as a public and private prosecutorial tool in organized crime and fraud cases. As demonstrated below, the Eighth Circuit ignored this Court's previously established standard to analyze RICO's statutory language, including the meaning of "conduct," as well as its correct (liberal) interpretation of the same word in 18 U.S.C. §1955.

**C. REFERENCE TO OTHER PROVISIONS OF OCCA DEMONSTRATES THAT THE APPLICABLE STANDARD IS WHETHER DEFENDANTS, PROFESSIONAL OR OTHERWISE, PERFORMED ACTS THAT ARE "HELPFUL" OR "NECESSARY" TO THE RICO ENTERPRISE**

<sup>38</sup> *Id.* at 1360. The Seventh Circuit cited numerous criminal and civil RICO cases from the Third, Fifth, Sixth, Seventh and Eighth Circuits in support of this statement. *Id.*

<sup>39</sup> 711 F.2d at 1360.

In construing §1962(c), the Eighth Circuit specifically rejected the standard stated by the Eleventh Circuit in *Bank of America Nat'l Trust & Savings Ass'n v. Touche Ross & Co.*,<sup>40</sup> where the defendant accounting firm allegedly prepared false audited financial statements which were submitted to five banks (including Bank of America) which extended credit in reliance upon those statements. The *Bank of America* court reversed the dismissal of a civil RICO complaint, rejecting the contention advanced by Touche and a number of its partners (who had been named as defendants in their individual capacity) that §1962(c) required allegations and proof of their participation in the operation or management of the enterprise:

Defendants argue that Congress intended to limit the reach of a civil RICO action by imposing a "conduct" requirement, i.e., that defendant conducted or participated in the conduct of a RICO enterprise in a significant manner. This argument ignores the "directly or indirectly" language of §1962(c).

The banks have alleged that defendants assisted in the preparation and dissemination of false financial statements. These financial statements were helpful to International Horizons because they allegedly induced the banks to lend money to the enterprise. The word "conduct" in §1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise.<sup>41</sup>

<sup>40</sup> 782 F.2d 966 (11th Cir. 1986). See *Arthur Young*, 937 F.2d at 1324 (refusing to follow *Bank of America* standard).

<sup>41</sup> *Id.* at 970 (citation omitted).

As *Bank of America* noted, the "necessary or helpful" standard it adopted<sup>42</sup> was originally stated by the Fifth Circuit in *United States v. Martino*,<sup>43</sup> a criminal RICO prosecution involving an association-in-fact enterprise formed for the purpose of purchasing properties and committing arson fraud. The court rejected the contention that §1962(c) applies "only to those who manage the enterprise, i.e., the top coterie,"<sup>44</sup> explaining that "[t]he word 'conduct' is neither illusive nor mysterious, nor is its use unique to RICO."<sup>45</sup> Indeed, *Martino* held that the term "conduct" found in §1962(c) of RICO should be interpreted by reference to other provisions of OCCA in which it was used by Congress and has been liberally interpreted by the courts:

[The word "conduct"] is found in other statutes including, *inter alia*, 18 U.S.C. §1955 which makes it a crime for one to conduct an illegal gambling business. In *United States v. Tucker*, 638 F.2d 1292 (5th Cir. 1981), we held that a waitress serving drinks to customers engaged in gambling conducts an illegal gambling business within the intendment of 18 U.S.C. §1955. We concluded in *Tucker* that the word "conducts" simply means the performance

<sup>42</sup> A number of civil RICO cases follow this standard in construing §1962(c). See, e.g., *Baggio v. EC Solar, Inc.*, No. 88 C 1893, 1990 U.S. Dist. LEXIS 5569, at \*27 (N.D. Ill. May 8, 1990); *First Finan. Savs. Bank, Inc. v. American Bankers Ins. Co.*, 699 F. Supp. 1167, 1172-73 (E.D.N.C. 1988); *Odesser v. Continental Bank*, 676 F. Supp. 1305, 1312 & n.3 (E.D. Pa. 1987); *Cincinnati Gas & Elec. Co. v. General Elec. Co.*, 656 F. Supp. 49, 86 (S.D. Ohio 1986); *In re Nat'l Mortgage Equity Corp. Mortgage Pool Certificates Securities Litig.*, 636 F. Supp. 1138, 1171 (C.D. Cal. 1986).

<sup>43</sup> 648 F.2d 367 (5th Cir. 1981), *cert. denied*, 456 U.S. 949 (1982), *on remand*, 681 F.2d 952 (5th Cir. 1982), *aff'd on other grounds sub nom.*, *Russello v. United States*, 464 U.S. 16 (1983).

<sup>44</sup> 648 F.2d at 382.

<sup>45</sup> *Id.*

of activities necessary or helpful to the operation of the enterprise.<sup>46</sup>

The approach adopted in *Martino* is surely the correct one because, as this Court recognized when interpreting the "pattern" element in *Northwestern Bell*, "we may take guidance from a provision elsewhere in [OCCA], of which RICO formed Title IX,"<sup>47</sup> and it interpreted the "pattern" element by reference to Title X of OCCA, the Dangerous Special Offender Sentencing Act.<sup>48</sup>

Section 1955 makes it a crime for one to "conduct" an illegal gambling business<sup>49</sup> and this Court has held that the

<sup>46</sup> 648 F.2d at 382. See also *United States v. Manzella*, 782 F.2d 533, 538 (5th Cir.) (customers of arson service can conspire to violate §1962(c) by buying the service offered), *cert. denied*, 476 U.S. 1123 (1986).

<sup>47</sup> 492 U.S. at 239 (citation omitted).

<sup>48</sup> *Id.* at 237-39 (citing 18 U.S.C. §3575 *et seq.* (now partially repealed)). In *Sedima*, 473 U.S. at 496 n.14, this Court also interpreted the "pattern" element by reference to §3575(e), stating that "[t]his language may be useful in interpreting other sections of" RICO. See also *Iannelli v. United States*, 420 U.S. 770, 788-89 (1975) (utilizing §1511 — proscribing conspiracies to obstruct state law enforcement efforts — to interpret §1955 — proscribing gambling syndicates), *ovrl'd on other grounds by Brown v. Ohio*, 432 U.S. 161 (1977).

<sup>49</sup> The statute provides in pertinent part:

Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined not more than \$20,000 or imprisoned not more than five years, or both.

18 U.S.C. §1955(a) (emphasis added). Section 1955 was enacted as Part C of Title VIII of OCCA and was aimed toward curtailing syndicated gambling. *United States v. Pinelli*, 890 F.2d 1461, 1470 & n.6 (10th Cir. 1989), *cert. denied*, 494 U.S. 1038 (1990). Congress' intent as to the precise meaning of "conduct" is neither defined by the statute nor explained in the legislative history of §1955; however, §§1511 and 1955 were enacted together as §§802 and 803 of OCCA and the same language is used in both statutes to define an "illegal gambling business." When referring to that statutory phrase in §1511, Congress stated:

The statute applies generally to persons who participate in the ownership, management, or conduct of an illegal gambling business. The term "conduct" refers both to high level bosses

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statute "proscribes any degree of participation in an illegal gambling business."<sup>50</sup> The Eighth Circuit expressly followed this Court's liberal interpretation of §1955's "conduct" element just five years ago in *United States v. Hammond*,<sup>51</sup> holding that a woman who knowingly permitted her telephone to be used in the operation of defendant's gambling enterprise in exchange for compensation and merely supplied the defendant with paper used to record bets "conducted" the gambling enterprise:

[S]ection 1955 includes anyone who participates in a gambling business other than a customer or bettor. The scope of [§]1955 is quite broad, all levels of personnel involved in the operation of a gambling business, not just those on the management level, are to be considered in determining whether five or more persons conduct such business within the meaning of [§]1955.<sup>52</sup>

The Eighth Circuit's analysis of the term "conduct" in

(fn. continued)

and street level employees.

1970 U.S. Code Cong. & Adm. News 4007, 4029 (1970); see also *United States v. Rieger*, 942 F.2d 230, 233-34 (3d Cir. 1991); *Pinelli*, 890 F.2d at 1470-71.

<sup>50</sup> *Sanabria v. United States*, 437 U.S. 54, 70 n.26 (1978) (emphasis added).

<sup>51</sup> 821 F.2d 473 (8th Cir.), *cert. denied*, 484 U.S. 986 (1987).

<sup>52</sup> 821 F.2d at 476 (citations omitted). Accordingly, the Eighth Circuit held that the trial court had properly instructed the jury as follows:

The term "conduct" as it is used in connection with the gambling business means to perform any act, function or duty which is necessary to or helpful in the ordinary operation of the business. A person may be found to conduct a gambling business even though he is a mere servant or employee having no part in the management or control of the business and no share in the profits.

*Id.* at 476 n.5 (citing E. Devitt & C. Blackmar, *Federal Jury Practice and Instructions*, §61.05 (1977)); see also *United States v. Grezo*, 566 F.2d 854, 860 (2d Cir. 1977) (quoting trial court's instruction as to the requisite elements of "conducting" a gambling business).

*Hammond* should have been followed when it interpreted the same word in this case.<sup>53</sup> Its failure to do so creates an extraordinary anomaly: waitresses who serve drinks to gamblers can be criminally convicted for the "conduct" of a gambling business under §1955(a) while auditors who knowingly issue "clean" audit opinions on an enterprise's fraudulent financial statements which are used to defraud thousands of innocent investors cannot be held civilly liable for the "conduct" of the enterprise's affairs under §1962(c). Surely this was not Congress' intent when it used the term "conduct" in OCCA!

Given this uniformly liberal interpretation of §1955,<sup>54</sup> a

<sup>53</sup> See *Arthur Young*, 937 F.2d at 1324. The Eighth Circuit is quite familiar with the proper construction of the term "conduct" found in §1955, since it has affirmed a number of convictions obtained in cases involving non-management employees of gambling syndicates. See, e.g., *United States v. Reeder*, 614 F.2d 1179, 1182 n.2 (8th Cir. 1980) (the test of "conduct" is whether the activities performed were necessary "or helpful" to the operation of the gambling business); *United States v. Bennett*, 563 F.2d 879, 883 (8th Cir.) (same — services provided by waitresses were "necessary" or "helpful" because they "allowed the gamblers to remain at the table and continue placing bets"), *cert. denied*, 434 U.S. 924 (1977); *United States v. Meese*, 479 F.2d 41, 43 (8th Cir. 1973) ("We hold that all levels of personnel involved in operating an illegal gambling business and not merely the management level are to be included in determining whether five or more persons conduct such business within the meaning of §1955.") (citations omitted).

<sup>54</sup> See, e.g., *United States v. Zannino*, 895 F.2d 1, 10 (1st Cir.) (§1955 "applies even to individuals who have no role in managing or controlling the business and who do not share in its profits.") (citation omitted) *cert. denied*, 494 U.S. 1082 (1990); *United States v. Riccobene*, 709 F.2d 214, 230 (3d Cir.) ("The evidence shows that he was an employee of the game — taking bets from people — and thus he may be considered to have 'conducted' a gambling business as is required by [§]1955."), *cert. denied*, 464 U.S. 849 (1983); *United States v. Jenkins*, 649 F.2d 273, 275 (4th Cir. 1981) (same — layoff man); *United States v. Tucker*, 638 F.2d 1292, 1295 (5th Cir. 1981) (waitresses who served drinks to gamblers, made change for them to use in placing bets in cash game, and delivered telephone messages to them performed functions necessary to or helpful in operation of gambling business); *United States v. Avarello*, 592 F.2d 1339, 1349 (5th Cir.) ("It is well settled . . . that the scope of [§1955] includes all those who

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similar statute enacted as part of OCCA, the analysis utilized by the court below is even more untenable and should be flatly rejected.

**D. REFERENCE TO THE SAVINGS AND LOAN CRISIS DEMONSTRATES HOW RESPONDENT'S PROFESSIONAL SERVICES HAVE BEEN "NECESSARY" OR "HELPFUL" TO THE OPERATION OF RICO ENTERPRISES WHICH HAVE DEFRAUDED THE GOVERNMENT AND THOUSANDS OF INNOCENT VICTIMS**

Our nation is embroiled in a continuing (and, indeed, deepening) bank and savings and loan crisis which has literally caused this generation to mortgage its (and at least the next two generations') economic futures. Respondent's (and other accounting firms') responsibility for the crisis cannot be underestimated,<sup>55</sup> yet it and other members of the accounting and legal professions clearly envision this case as

(fn. continued)

participate in the operation of an illegal gambling business, except customers or mere bettors, regardless of how minor their roles. Thus, persons who perform a necessary function in the operating of illegal gambling — whether they be labelled writers, agents, runners, watchmen, telephone clerks, collectors, or subbookmakers — "conduct an illegal gambling business." (citation omitted), *cert. denied*, 444 U.S. 844 (1979).

<sup>55</sup> In a recent decision enforcing a subpoena issued by the Office of Thrift Supervision (OTS), which sought to compel Respondent to turn over documents relating to its audit and accounting work on behalf of 23 troubled or failed thrift institutions, Judge Lamberth wrote that "[a]ccounting firms may have been responsible for many of the abuses which have led to this country's savings and loan crisis," noting that the OTS had advised the court that "approximately one-third of the 690 financial institutions that have failed were audited by Ernst & Young or its predecessor," *Arthur Young*. The losses caused by just four of the 23 institutions OTS is currently investigating — Lincoln Savings, Silverado Savings, Vernon Savings and Western Savings — have been estimated to total more than \$5.5 billion, as the court noted. *Director of Office of Thrift Supervision v. Ernst & Young*, Misc. No. 91-401 (RCL), 1992 U.S. Dist. LEXIS 2315, at \*19 (D.D.C. Mar. 3, 1992).

providing an opportunity to emasculate RICO and shield them from the ruinous (and well-deserved) potential liability they face for their undeniable roles in this crisis.<sup>56</sup>

One pending case which typifies Respondent's (and other professionals') liability for wrongdoing in connection with a failed thrift institution involves convicted felon Keating's ACC/Lincoln Savings. Three (of the so-called "Big Six") accounting firms — Respondent, Arthur Andersen & Co.<sup>57</sup>

<sup>56</sup> In assessing the causes and impact of the bank and thrift crisis, careful attention must be paid to critical roles played by professionals — attorneys, accountants, loan brokers, investment bankers and real estate appraisers — who abandoned their professional ethics and willfully joined the "chain of greed" which epitomized the "thrifts'" operations and eventual downfall. One reporter explained that "crimes in thrifts . . . often required the cooperation of groups of people, in what might be called a 'chain of greed'":

[T]he chains involved five kinds of professionals, in addition to the borrowers who benefitted from the questionable loans. At the beginning of a transaction, *real estate brokers* masterminded the shady deals. Crooked *appraisers* then inflated real estate values to make the deals work. Inside the institutions, an array of *employees* from loan officers hungry for a loan commission to the executives themselves participated in the fraud. At the conclusion of a deal, *lawyers* "papered" the bogus transactions by drawing up the contracts, and *accountants* either looked the other way or neglected to scour the institutions' books too carefully.

Harris, *The S&L Looters Who May Get Away*, Wall St. J., Feb. 12, 1990, at A12, col. 3 (emphasis in original); see also France, *Savings & Loan Lawyers*, 77 A.B.A.J. 52 (May 1991) (observing that critical roles were often played by attorneys who aided and abetted thrift institutions' criminal wrongdoing).

<sup>57</sup> Arthur Andersen received \$3.7 million for providing clean audit opinions to ACC/Lincoln Savings in 1984 and 1985. According to thrift regulators, it fraudulently backdated loan file data and "stuffed" files with loan documentation. See Thomas, *Regulators Cite Delays and Phone Bugs in Examination, Seizure of Lincoln S&L*, Wall St. J., Oct. 27, 1989, at A4, col. 2; J. Granelli, *Keating Trial Focuses on Advisers*, L.A. Times, Mar. 14, 1992, at D1, col. 3. Although it steadfastly denied wrongdoing, following plaintiffs' opening statement in the pending RICO class action trial it agreed to pay \$30 million to settle claims asserted by stockholders and bondholders. D. Jefferson & L. Berton, *Accounting Firm to Settle Suit on Thrift*, Wall St. J., Mar. 17, 1992, at A4, col. 1.

and Touche Ross & Co. — are implicated in the \$2.5 billion collapse of Keating's feudal kingdom, while several so-called "national" law firms have also been charged with wrongdoing in the scandal.<sup>58</sup> Reduced to its essentials, investors allege that Respondent received \$7 million in fees to provide the ACC/Lincoln Savings RICO enterprise with "clean" audit opinions for 1986 and 1987 which permitted the sale of over \$200 million of junk bonds to thousands of elderly investors specifically targeted by Keating and his co-conspirators as "the weak, meek and ignorant."<sup>59</sup> In addition, during 1987 and 1988 Respondent's lead partner on the ACC/Lincoln audits, Jack Atchison, wrote advocacy letters to numerous U.S. Senators, met with at least one of them in a successful effort to convince several Senators ("the Keating Five") to intervene on Keating's behalf with federal regulators and misrepresented Lincoln's collapsing financial condition to regulators. The resulting two-year delay before regulators could seize Lincoln Savings will cost the taxpayers at least an additional \$1 billion.<sup>60</sup> Immediately after

<sup>58</sup> ACC/Lincoln Savings' outside counsel, New York's Kaye, Scholer, Fierman, Hays & Handler, which was accused of aiding and abetting a fraudulent scheme to mislead investors by assisting in the preparation of a misleading initial securities prospectus, characterized ACC/Lincoln Savings investors' claims as "frivolous" and "ridiculous" when they were initially filed in 1989. See *S&L Scandal Snares a Big Firm*, Nat'l L. J., May 29, 1989, at 3. Just one year later, however, Kaye Scholer paid \$20 million to settle those same claims. *Law Firm in Lincoln S&L Suit Agrees to Pay \$20 Million*, S.F. Chron., June 16, 1990, at A1; see also Note, *Securities Attorneys Face Liability For Wrongs of Their Corporate Clients*, 5 J. of Legal Comment. 403, 406-08 (1990) (detailing Kaye Scholer's involvement in Keating's multi-faceted fraudulent schemes).

<sup>59</sup> See Nash, *Auditors of Lincoln on the Spot*, N.Y. Times, Nov. 14, 1989, at D1, col. 3. Although federal and state examiners had issued examination reports stating that Lincoln was insolvent, Respondent did not mention in its audit opinions Lincoln's potential problems. *Id.*

<sup>60</sup> See Jackson, *New Disclosures of Riegle's Lincoln Role Suggest He Was More Than a Bystander*, Wall St. J., Nov. 15, 1989, at A28, col. 1; Jackson, *FBI Probe Focuses on Senators' Ties to Keating's S&L*, Wall St. J., Nov. 13, 1989, at A7B, col. 2; *The Senate Five*, N.Y. Times, Oct. 23, 1989, at

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Respondent issued the year-end 1987 clean audit opinion for ACC/Lincoln, Atchison resigned from the accounting firm and accepted a job from Keating at a four-fold increase in his annual compensation.<sup>61</sup> In essence, as the Lincoln Savings example illustrates, Respondent (and other accountants) ignored the importance of the audit function as well as their roles as public watchdogs<sup>62</sup> when they prostituted

(fn. continued)

A18, col. 1; Stanton, *House Orders Subpoenas in Keating Case*, Ariz. Republic, Oct. 13, 1989, at A1, col. 1; Kammer & Hall, *Lincoln's "Kamikaze Banking": Wallflower Thrift Became High Roller*, Ariz. Republic, Sept. 16, 1989, at A2, col. 1.

<sup>61</sup> See Blakey, *An Analysis of the Myths That Bolster Efforts to Rewrite RICO and the Various Proposals for Reform*, 43 Vand. L. Rev. 851, 888-91 & nn.108-10 (1990) (detailing Respondent's involvement in the Lincoln Savings debacle). Judge Stanley Sporkin, who tried one aspect of the litigation relating to the catastrophic failure of Lincoln Savings, highlighted in pointed language the role played by professionals who instigated and/or aided and abetted the fraudulent operation of now-failed thrift institutions. Referring to Atchison, who resisted discovery in the investors' class action suit by invoking the privilege against self-incrimination, Judge Sporkin asked, "Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?" *Lincoln Savs. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990).

<sup>62</sup> As ACC/Lincoln illustrates, Respondent and other accounting firms have persistently ignored this Court's explicit statement of the accounting profession's "public watchdog" role:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

(continued)

themselves for errant thrift operators.<sup>63</sup>

There can be no doubt that Respondent's (and other professionals') activities were "necessary" or "helpful" in the conduct of the ACC/Lincoln Savings enterprise's affairs, yet the Eighth Circuit's analysis of the "conduct" element in the

(fn. continued)

*United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984) (emphasis in original). In language which can only be regarded as prescient of Respondent's (and Atchison's) role in the ACC/Lincoln Savings scandal, this Court also stated that "[i]f investors were to view the auditor as an advocate for a corporate client, the value of the audit function itself might well be lost." *Id.* at 820 n.15 (emphasis added) (citing A. Arens & J. Loebbecke, *Auditing: An Integrated Approach* 55-58 (1976)).

<sup>63</sup> Running through the ongoing savings and loan crisis is the general problem of fraudulent financial reporting. When such aberrant behavior occurs, widespread consequences result, sometimes causing a devastating ripple effect. See *Report of the National Commission on Fraudulent Financial Reporting* 4 (1987). The General Accounting Office has been sharply critical of the accounting profession — most notably, Respondent — for its utter failure to uncover the widespread fraud in these failing financial institutions:

We concluded that for 6 of the 11 S&Ls, CPA's did not adequately audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards. The CPAs' problems involved (1) inadequate audit work in evaluating loan collectibility and (2) inadequate reporting on S&Ls' accounting practices, regulatory compliance, and internal controls. The nature of the audit and reporting problems was significant enough to warrant our referring the CPA firms performing the audits to regulatory and professional bodies for their review.

The latest audit reports for the 11 S&Ls before they failed showed combined positive net worth totaling approximately \$44 million. At the time of the S&Ls' failures, which ranged from 5 to 17 months after the date of the last audit reports, the 11 S&Ls had combined negative net worth totaling approximately \$1.5 billion.

General Accounting Office, *CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems* 1 (1989); see also Wayne, *Where Were the Accountants?*, N.Y. Times, Mar. 12, 1989, §3, at 1, col. 2 (detailing accounting firms' potential liability in thrift crisis).

instant case suggests that it would find that Respondent did not "participat[e] in the operation or management" of the enterprise and improperly absolve it of RICO liability.<sup>64</sup> Under the standard adopted in other circuits in criminal and civil RICO cases, Respondent's activities would surely subject it to liability under §1962(c) in fraudulent schemes similar to that involved in *ACC/Lincoln Savings*, yet the Eighth Circuit would invariably shield such culpable involvement in directly or indirectly conducting an enterprise's affairs from civil or criminal liability. Given its developing record of pervasive wrongdoing which has already led to multi-billion dollar costs to the American taxpayer, Respondent's effort in this case to render RICO useless as a prosecutorial tool utilized by Government agencies such as the OTS, Resolution Trust Corporation and Federal Deposit Insurance Corporation, as well as defrauded investors, entities and consumers should be resisted.

#### CONCLUSION

NASCAT respectfully urges this Court to reverse the decision of the court below and to adopt the standard of liability under §1962(c) stated by the Eleventh Circuit in *Bank of America* and recognized by the courts uniformly construing §1955(a), which will reaffirm RICO's noble purpose to combat organized crime and fraud which Congress charted a generation ago.

DATED: April 9, 1992

Respectfully submitted,  
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*Counsel for Amicus Curiae*

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<sup>64</sup> *Arthur Young*, 937 F.2d at 1324.

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No. 91-886

Supreme Court, U.S.  
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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

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**BOB REVES, ROBERT H. GIBBS,  
and FRANCES GRAHAM, as Representatives  
of a Class of Note Holders,**

*Petitioners,*

v.

**ERNST & YOUNG,**

*Respondent.*

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**On Writ of Certiorari to the United  
States Court of Appeals for the Eighth Circuit**

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**BRIEF OF AMICUS CURIAE  
NATIONAL ASSOCIATION OF INSURANCE  
COMMISSIONERS, IN SUPPORT OF PETITIONERS**

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No. 91-886

IN THE

**Supreme Court of the United States**

OCTOBER TERM, 1991

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**BOB REVES, ROBERT H. GIBBS,  
and FRANCES GRAHAM, as Representatives  
of a Class of Note Holders,**

*Petitioners,*

v.

**ERNST & YOUNG,**

*Respondent.*

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**On Writ of Certiorari to the United  
States Court of Appeals for the Eighth Circuit**

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**BRIEF OF AMICUS CURIAE  
NATIONAL ASSOCIATION OF INSURANCE  
COMMISSIONERS, IN SUPPORT OF PETITIONERS**

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**INTEREST OF THE AMICUS CURIAE  
NATIONAL ASSOCIATION  
OF INSURANCE COMMISSIONERS**

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The National Association of Insurance Commissioners ("the NAIC") is a voluntary unincorporated association comprised of the chief insurance regulatory officials with

principal responsibility for supervising the business of insurance in the states, territories, and insular possessions of the United States. As stated in its constitution, the organization aims to help state officials achieve fundamental insurance regulatory objectives, among which is effective financial solvency regulation.

This objective has assumed special prominence in recent years as the failure of major insurers has left millions of policyholders holding worthless policies and annuities. The NAIC's members have found that their ability to identify a company in financial distress in time to avert failure requires that they receive complete and honest information about the financial condition of the companies they regulate. Fraud and other acts of dishonesty in reporting financial information frustrate this solvency regulatory process, whether the dishonesty is attributable to company owners and managers or independent consultants, such as auditors, actuaries and attorneys, all of whom are essential participants in the financial reporting process.

Where an insurance company's failure is the result of fraud or other dishonesty, the NAIC's members believe the perpetrators should be punished and, if possible, the victims—including the defrauded company and its policyholders—compensated by the wrongdoers. The members have found RICO, including both its criminal penalties and civil remedies, to be a strong and useful enforcement tool. Therefore, the NAIC, in assisting its members to fulfill the fundamental regulatory objective of effective solvency regulation, has a direct interest in assuring the continued availability of civil and criminal RICO as a vehicle for compensating its victims and for punishing dishonesty, whether perpetrated by company management or by independent entities and consultants.

The NAIC's members believe that the Eighth Circuit's interpretation of RICO's "participation" element shields independent entities and consultants from RICO liability, even where their conduct has been essential to the perpetration of an illegal scheme that has caused or concealed an insurance company's insolvency. To this end, the NAIC supports the position of the Petitioners in urging the reversal of the Eighth Circuit opinion. The parties have consented to the filing of this brief, and the consents are on file with the Clerk of the Court.

### SUMMARY OF ARGUMENT

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The Eighth Circuit held that an accounting firm that misrepresented its audit client as solvent when in fact it knew the client was insolvent could not be liable for a RICO violation, because an outside auditor does not "operate" or "manage" the client company, and therefore cannot participate, even indirectly, in the conduct of its affairs within the meaning of RICO, 18 U.S.C. §1962(c). But the key actors in successful frauds involving the illegal operation of insurance companies invariably include independent entities, such as insurance agencies, brokers and reinsurers, and consultants, such as accountants, actuaries and attorneys. Therefore, if the Eighth Circuit's holding is affirmed, these wrongdoers will be effectively immunized from RICO prosecution, even where their misconduct proximately caused injuries to insurance companies and their policyholders.

The holding should not, however, be affirmed. It ignores the plain language of RICO, which proscribes misconduct

by those who directly and *indirectly* participate in the conduct of a company's affairs, and so it is contrary to Congress's intent that the statute apply to independent third parties as well as company insiders; it eviscerates RICO as a weapon against fraudfeasors who happen not to be part of the inside management team; and it is not necessary for preventing frivolous RICO claims from clogging our courts.

Recent insurance company failures, caused or concealed by fraud and deceit in the operation of the failed companies and false financial reporting about the failed companies, have already cost the American public many billions of dollars. A congressional subcommittee studying whether the insurance industry will suffer a disaster in the 1990's of the same magnitude as the savings and loan disaster of the 1980's, recently encouraged responsible officials to pursue those—company insiders and independent entities and consultants alike—who commit frauds against insurance companies. Insurance officials charged with liquidating the estates of insolvent insurers have successfully used RICO to recover damages from both company insiders and outside entities and consultants on behalf of the insolvent insurers and their policyholders. The NAIC and its member state officials, therefore, urge that the Eighth Circuit's decision be reversed in order to preserve the scope of RICO as a forceful deterrent and remedial provision.

## ARGUMENT

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A federal jury found the accounting firm, Arthur Young & Co., guilty of acts of federal and state securities fraud in connection with its audits of a grain cooperative ("the Co-op"). The victims of the fraud were farmer-members of the Co-op, who lent it money on the strength of Arthur Young's representations—which turned out to be *misrepresentations*—about the Co-op's financial condition. The jury was not allowed, however, to consider whether Arthur Young also violated RICO, 18 U.S.C. §1962(c),<sup>1</sup> because the district court held that, as a matter of law, an auditor's involvement with its client does not constitute "participation" in the conduct of its client's affairs within the meaning of the statute. On review, the Eighth Circuit characterized Arthur Young's actions as "reprehensible," but affirmed the lower court's decision, because under its view, one who does not "operate" or "manage" the entity identified as the RICO enterprise cannot participate, even indirectly, in the conduct of its affairs within the meaning of section 1962(c). *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1324 (8th Cir. 1991).

If this decision is affirmed, it will render RICO useless as a tool for pursuing those whose illegal operation of insurance companies has ruined solid businesses, left policy-

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<sup>1</sup> Section 1962(c) provides:

It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

holders with worthless claims against insolvent companies, and imposed a multi-billion dollar burden on the American public.<sup>2</sup> For this reason, the NAIC and its member state insurance regulators join the petitioners in urging reversal of the Eighth Circuit decision.

**A. The Illegal Operation of an Insurance Company Generally Requires the Culpable Involvement of Independent Entities and Consultants.**

Insurance companies, the repositories of huge sums of money derived from policyholders' premium dollars, are attractive targets of fraud.<sup>3</sup> There are two typical configurations of fraud involving the illegal operation of insurance companies. In one, the company's assets are siphoned off, usually through affiliates, agents, and reinsurers. In the other, the company's insolvency is concealed so that it can continue to take in money by selling policies that later turn out to be of no value.

<sup>2</sup> A Congressional subcommittee ("the Dingell Committee") investigating the causes of insurance company insolvencies found that four recent failures—all of which the subcommittee attributed at least in part to fraud and deceit—would alone cost the public \$5 billion. Staff of House Comm. on Energy and Commerce, 101st Cong. 2d Sess., "Failed Promises; Insurance Company Insolvencies" at 2-3 (Comm. Print 101-P 1990) [hereinafter cited as *Failed Promises*].

<sup>3</sup> As the Dingell Committee explained it:

The business of insurance is uniquely suited to abuse by mismanagement and fraud. Making believable promises is a stock item in every con man's bag of tricks. The prepayment of large, often vast, sums of money with few restrictions lends itself naturally to monumental wasting of assets through greed, incompetence, and dereliction of duty. This combination of easy money based on easy promises makes the insurance industry an irresistible target for financial knaves and buccaneers.

*Failed Promises* at 3.

Most often, these frauds are perpetrated as the joint effort of company management or employees and third party wrongdoers, and result in bankrupting solvent companies or deepening an already existing insolvency. For example, the Dingell Committee concluded that the failure of Mission Insurance Company, one of the largest insurance company insolvencies in history, was fueled by the deceit of agents and reinsurers doing business with Mission; and that it was concealed by false financial reports filed with regulators by Mission and the auditors of Mission's parent. *Failed Promises* at 16-21.

This deceit was not unique to Mission. Many documented frauds against insurance companies involve third parties acting in concert with company managers to skim money through inflated commissions and fees.<sup>4</sup> Others involve fraudulent investments of policyholder premium dollars in sweetheart deals or non-performing loans;<sup>5</sup> and still others involve complex schemes with third parties in which sham reinsurance is used artificially to inflate policyholders' surplus.<sup>6</sup>

<sup>4</sup> E.g., *Curiale v. Peat, Marwick, Mitchell & Co.*, No. 2310/87 (N.Y. Sup. Ct. N.Y. Cty., Jan. 10, 1992) (alleged diversion of \$10 million in excessive management fees; summary judgment denied); *State of Florida Department of Insurance v. Merrill Lynch*, No. 91-17911 (Circuit Ct. Duval Cty., Florida, filed Dec. 20, 1991) (liquidator's complaint alleging looting through excessive fees, compensation and illegal dividends, as well as fraudulent scheme to conceal insurer's insolvency).

<sup>5</sup> For example, the Dingell Committee singled out the "irresponsible junk bond practices" of First Executive Corporation. *Failed Promises* at 7.

<sup>6</sup> *Failed Promises* at 42 describes a sham reinsurance scheme that enabled Transit Casualty Company to lull regulators by reporting a stable surplus when in fact the company was insolvent by billions of dollars. See also *Levine v. American Federal Group, Ltd.*, Mealey's Insurance Insolvency, March 18, 1992 at C-1 (N.Y. App.Div. 1992) (dispute involving broker who allegedly placed reinsurance with a reinsurer known to be insolvent).

A goal of insurance regulation is detecting these frauds before they cause company failure. But most of the regulators' information about insurance companies comes from the companies themselves, primarily through detailed financial statements filed with the regulators at least annually. Thus, where the illegal scheme includes concealing a failing or insolvent financial condition through, for example, fraudulently underreported loss reserves or sham reinsurance, the regulators' ability to detect the fraud is dependent in the first instance on the honesty of persons who, in fact, are perpetrating and concealing it. Negligence and defalcations in financial reporting have prompted regulators to require companies to provide actuarial opinions on the adequacy of loss reserves and to obtain annual audits of their balance sheets and income statements from independent certified public accountants.<sup>7</sup> The regulatory purposes of these initiatives are obviously frustrated when consulting actuaries and independent auditors lend their prestige and knowingly join management's scheme to cover up an insurer's true financial condition.

**B. Civil RICO Is a Tested and Successful Weapon in the Fight Against Fraudulent Operation of Insurance Companies.**

The mail and wire fraud statutes have always been effective vehicles for criminally prosecuting those involved in the fraudulent operation of insurance companies.<sup>8</sup> What

<sup>7</sup> The so-called audit rule, which has been in force in some states since the 1970's, e.g., 50 Ill. Admin. Code 925 (1975), was recently adopted as an amendment to the Annual Statement Instructions, and thereby made applicable in all states. Vol.IA 1991 *Proceedings of the NAIC* 319.

<sup>8</sup> E.g., *United States v. Cosentino*, 869 F.2d 301 (7th Cir.), cert. denied, 492 U.S. 908 (1989) (criminal conviction for siphoning off

(Footnote continued on following page)

was historically missing, however, were effective civil remedies for compensating the victims of the frauds—the companies and their policyholders. RICO has filled that gap.

The first civil RICO complaint on behalf of a defrauded insurance company, filed in 1981, is described in *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1003 (1983). Schacht was the liquidator of Reserve Insurance Company, an insolvent Illinois property and casualty insurer faced with a \$100 million deficit. He brought a RICO suit against the company's officers, directors, reinsurers, auditors and others. As the Seventh Circuit described it, the defendants were charged under 18 U.S.C. §1962(c) with participation in a "multifaceted, fraudulent scheme, which kept Reserve operating long past insolvency in a manner which resulted in enormous losses to the latter company." 711 F.2d at 1346. The scheme could not have succeeded without the help of the third party wrongdoers: the reinsurer, which (the complaint alleged), in exchange for a multimillion dollar fee, entered a financing transaction that was falsely presented on Reserve's financial statements as reinsurance; and the auditors who (allegedly) consented to the false and misleading presentation of the financing transaction in Reserve's financial state-

<sup>8</sup> continued

insurance company assets through affiliated broker affirmed); *United States v. Joyce*, 499 F.2d 9 (7th Cir.), cert. denied, 419 U.S. 1031 (1974) (affirming mail fraud conviction of schemers who persuaded people to place insurance with an under-capitalized insurance company and then siphoned off the premium dollars for personal use); *United States v. Kreimer*, 609 F.2d 126 (5th Cir. 1980) (affirming conviction where an insurance company was defrauded by agents who accepted secret fees and commissions for policies they wrote for the company).

ments and failed to disclose Reserve's insolvency. *Id.* at 1345.<sup>9</sup>

Other liquidators of insolvent insurers who have sued under RICO have also achieved recoveries on behalf of defrauded companies. As examples, the liquidator of Beacon Insurance Company recently obtained a multimillion dollar settlement of a RICO suit against a group of agents and brokers who, he claimed, defrauded Beacon into accepting imprudent risks for insufficient premiums. *See generally State of North Carolina ex rel. Long v. Alexander & Alexander*, 680 F.Supp. 746 (E.D.N.C. 1988) and No. 86-1247-Civ.-5 (E.D.N.C. Jan. 22, 1992) (dismissal order). And a jury ordered the majority shareholder of an insolvent Texas insurer to pay in excess of \$1 million (trebled) in RICO damages for his participation in a scheme to siphon off company assets through excessive commission payments to an agency owned by the shareholder. *Durish v. Usselton*, Mealey's Insurance Insolvency, August 15, 1990 at D-1 (N.D. Texas 1990).<sup>10</sup>

<sup>9</sup> The Reserve litigation recently settled. *Stamp v. Brown*, No. 81 C 1475 (N.D. Ill., Feb. 20, 1992) (dismissal orders). By agreement of the parties the dollar amount of the settlement will be disclosed later this month.

<sup>10</sup> At least two other liquidators are presently pursuing RICO claims on behalf of an insolvent insurer. Last year the liquidator of the insolvent Coastal Insurance Company filed RICO claims against persons and entities who allegedly diverted premium dollars earmarked for Coastal to themselves. *Garamendi v. Harry O. Miller et al.*, No. BC007903 (Super. Ct. Los Angeles Cty., Calif., filed August 10, 1990); and *Gallinger et al. v. B.D. Owens et al.*, CV 91-1867 PHXWPC (D. Ariz., filed Nov. 25, 1991).

Several others have filed RICO claims that were dismissed as untimely or because of pleading deficiencies. *See Hunt v. American Bank & Trust Co. of Baton Rouge*, 783 F.2d 1011 (11th Cir. 1986) (RICO claims for siphoning off insurer's assets dismissed as time-barred); *Corcoran v. American Plan Corp.*, 886 F.2d 16 (2d Cir.

(Footnote continued on following page)

The success of these prosecutions is attributable to the availability of RICO. The liquidators' state remedies for fraud are burdened in ways RICO is not. These burdens include state law privileges, inapplicable in federal question cases, that protect the auditors of insurance companies from having to produce their workpapers, even when the auditors are sued for participation in schemes to defraud the audited company;<sup>11</sup> complicated and uneven state laws of contribution and joint and several liability that are inapplicable in RICO suits,<sup>12</sup> but may allow culpable defendants sued on state causes to avoid some or all liability;<sup>13</sup> and problems of service and venue presented

<sup>10</sup> continued

1989) (liquidator's RICO suit against persons and entities who allegedly looted two defunct New York insurers dismissed under the Second Circuit's rule that there is no mail fraud violation in the absence of a coalescence between the person deceived—there, the regulators—and the person injured—the insurance companies).

<sup>11</sup> For example, in Illinois an accountant is protected from producing its audit workpapers in discovery by the so-called "Accountant's Privilege," Ill.Rev.Stat. ch.111, §5533, which the auditor defendants unsuccessfully invoked in the Reserve Insurance Company RICO action. The same auditors were, however, successful in preventing access to the same workpapers by bank creditors of Reserve's holding company in their state law civil fraud suits. *LaSalle National Bank v. Arthur Andersen*, No. 82 L 17602 (Cir. Ct. Cook Cty., Ill., July 27, 1984) (order denying plaintiff access to audit workpapers due to state law accountant privilege).

<sup>12</sup> The courts that have considered the issue have all held that contribution is not available as to RICO liability. *Miller v. Affiliated Financial Corp.*, 624 F.Supp. 1003 (N.D.Ill. 1985); *Minpeco, S.A. v. Conticommodity Services, Inc.*, 677 F.Supp. 151 (S.D.N.Y. 1988); *Dept. of Economic Development v. Arthur Andersen & Co.*, 747 F.Supp. 922 (S.D.N.Y. 1990); and *cf.*, *Fleischhauer v. Feltner*, 879 F.2d 1290 (6th Cir. 1989), *cert. denied*, 494 U.S. 1027 (1990) (RICO liability is joint and several).

<sup>13</sup> A total of twelve states have abolished joint and several liability, ten by statute—Arizona, Colorado, Connecticut, Idaho, In-

(Footnote continued on following page)

by state law actions involving a complex scheme, wrongful conduct and injury spanning several states, and multiple defendants, which are pretermitted by RICO's liberal venue and nationwide service of process provisions.

**C. The Court Should Adopt the Seventh Circuit's Definition of "Participate," Because It Is Consistent With the Meaning of the Plain Language of the Statute.**

The successful civil RICO prosecutions brought by the Reserve, Beacon and Texas Fidelity liquidators would have been stillborn if they had been filed in the Eighth Circuit, where the rule is that one who does not "operate" or "manage" the entity identified as the RICO enterprise cannot participate, even indirectly, in the conduct of its affairs within the meaning of section 1962(c). *Arthur Young & Co. v. Reves*, *supra* 937 F.2d at 1324. Key actors in the schemes that ruined Reserve, Beacon and Texas Fidelity were accountants, outside consultants and other third party wrongdoers: in Reserve they included the company's auditors and reinsurers; in Beacon and Texas Fidelity they included brokers and agents.

These wrongdoers would have been excluded from the litigation and insulated from liability under the *Arthur Young* rule; and the liquidators would have been handicapped in their ability to discover, present and, of course, remedy the full scope of the illegal conduct. In fact, as

<sup>13</sup> *continued*

diana, Michigan, New Mexico, North Dakota, Utah and Wyoming; and two by judicial decision—Kansas and Oklahoma. In these states, a plaintiff may not seek to recover from one or more defendants for the entire injury caused as a result of tortious conduct, but can instead recover only from each defendant based on its proportionate liability.

a practical matter, where the RICO enterprise is a legitimate company, the Eighth Circuit rule immunizes all persons except company ownership and management from section 1962(c) liability.<sup>14</sup> In turn, the rule eviscerates RICO as an effective remedy for the victims of most frauds involving the illegal operation of insurance companies. This is an unfortunate and unnecessary result.

Section 1962(c) provides that it shall be unlawful for any person employed by or associated with an enterprise "to conduct or participate, directly or indirectly, in the conduct of [an] enterprise's affairs" through a pattern of racketeering activity. In its "operate" or "manage" construction of the participation element, the Eighth Circuit has ignored the disjunctive wording of the statute: "conduct or participate, directly or indirectly, in the conduct." By holding instead that a RICO defendant *must* conduct (defined as "operate" or "manage") the enterprise's affairs, it has read out of Congress's plain language the words "or participate, directly or indirectly in the conduct."

Other courts have not been so miserly in their reading of the statute, and as a result, in other circuits RICO has been available as a prosecutorial tool against all persons involved in enterprise crimes. As the Eleventh Circuit

<sup>14</sup> It does not appear that even artful and circumspect pleading can evade the force of the *Arthur Young* rule. In that case, for example, the plaintiffs had alleged the audit firm, in whose affairs the individual auditors had plainly participated, as a RICO enterprise. The district court held this was insufficient, because in its view the illegal acts charged were not "typical of the practice of these professionals," from which the court concluded that the affairs of the firm were not conducted "through" a pattern of racketeering activity. *Robertson v. White*, No. 85-2044 (W.D. Ark., Oct. 15, 1986) (granting various motions for summary judgment) Pet.App. at 72-3.

held in reversing a motion to dismiss an audit firm charged under section 1962(c) with participating in the affairs of its client, the alleged enterprise:

It is not necessary that a RICO defendant participate in the management or operation of the enterprise. On its face, the statute requires only that the defendant "participate, directly or indirectly in the conduct of [the] enterprise's affairs. . . ." 18 U.S.C. § 1962(c). . . . Defendants argue that Congress intended to limit the reach of a civil RICO action by imposing a "conduct" requirement, i.e., that defendant conducted or participated in the conduct of a RICO enterprise in a significant manner. This argument ignores the "directly or indirectly" language of § 1962(c).

*Bank of America National Trust & Savings Association v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986).

The circuit with the most fully developed jurisprudence on the "participation" element of RICO is the Seventh. That court views the statute as sufficiently broad to encompass third party wrongdoers where: (1) they commit the racketeering acts; (2) their position in or relation with the enterprise facilitated commission of the acts, and (3) the acts had "some effect" on the enterprise. *United States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988). As the Seventh Circuit has explained:

The participation in the conspiracy of people who were not on the legitimate payroll of [the company] does not mean those people were not participating in its affairs. The nature of racketeering connections to an otherwise legitimate business suggests that elements outside a company may assist in obtaining the company's illegal goals.

*United States v. Starnes*, 644 F.2d 673, 679 (7th Cir.), cert. denied, 454 U.S. 826 (1981) (affirming the section 1962(c)

conviction of an arsonist hired by the corporate president to burn the enterprise/company's property). See also *United States v. Blackwood*, 768 F.2d 131 (7th Cir.), cert. denied, 474 U.S. 1020 (1985) (affirming the section 1962(c) conviction of a police officer who passed bribes to judges of the enterprise/court); *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987) ("[C]onduct in section 1962(c) does not mean 'control' or 'manage,' . . ." Therefore, an employee of a division of a subsidiary of the charged enterprise/corporation can participate in the conduct of the corporation's affairs within the meaning of section 1962(c)); *United States v. Yonan*, 800 F.2d 164, 167 (7th Cir. 1986), cert. denied, 479 U.S. 1055 (1987) (attorney who bribed state prosecutors participated in the affairs of the enterprise/prosecutors' office by conducting business with it, even though he did not have a "stake or interest" in its goals).<sup>15</sup>

<sup>15</sup> As petitioners have pointed out, other circuits including at least the Second, Third, Fifth, Sixth and Ninth, articulate the participation element in slightly different words than the Seventh and Eleventh, but the results are the same: outsiders to the enterprise who affect its affairs may be reached under section 1962(c). E.g., *United States v. Provenzano*, 688 F.2d 194 (3rd Cir.), cert. denied, 459 U.S. 1077 (1982) (owner of trucking companies liable for section 1962(c) violation where he participated in scheme to bribe an enterprise/union); *Town of Kearny v. Hudson Meadows Urban Renewal*, 829 F.2d 1263, 1266 (3rd Cir. 1987) (defendants not named in association-in-fact enterprise are still liable under section 1962(c) whether they are found to be "inside the enterprise or outside it."); *United States v. Bright*, 630 F.2d 804, 831 (5th Cir. 1980) (bonding company that bribed enterprise/sheriff's office participated in the affairs of the sheriff's office); *United States v. Elliott*, 571 F.2d 880, 903 (5th Cir.), cert. denied sub nom. *Delph v. United States*, 439 U.S. 953 (1978) ("The substantive proscriptions of the RICO statute apply to insiders and outsiders—those merely 'associated with' an enterprise—who participate directly and indirectly in the enterprise's affairs"); *United States v. Forsythe*, 560 F.2d 1127, 1136 (3rd Cir. 1977) (magistrate who accepts bribes from an enterprise/bonding company is sufficiently "associated with" the enterprise);

(Footnote continued on following page)

It is the Seventh Circuit's construction of the statute, and not the Eighth Circuit's, that gives full effect to Congress's intent, as expressed in the words it chose for section 1962(c), that RICO reach every person who joins in an enterprise crime—insiders and outsiders alike.<sup>15</sup> This Court has rebuffed all attempts to read into or out of RICO requirements that do not appear in its plain language. *E.g.*, *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479 (1985) (holding RICO is to be "read broadly" and that "amorphous standing requirements" should not be imposed on civil RICO). There is no principled reason to read the words "or participate, directly or indirectly, in the conduct of" out of section 1962(c). To do so would eliminate liability for persons and entities who have engaged in conduct otherwise proscribed by RICO.

<sup>15</sup> continued

*State of New York v. O'Hara*, 652 F.Supp. 1049, 1054 (W.D.N.Y. 1987) (contractor who submitted fraudulent bids on a municipal waste clean-up contract participated in the affairs of the enterprise/city); *Virden v. Graphics One*, 623 F.Supp. 1417 (C.D. Cal. 1985) (misrepresentations of subsidiary were sufficiently related to enterprise/parent corporation to be actionable under section 1962(c)).

<sup>16</sup> In addition to the plain language of the statute, the legislative history of RICO also suggests that it was intended to reach beyond those who own or manage an enterprise. For example, those speaking in favor of the bill during the House debate noted it was designed to snare accounting firms, 113 *Cong. Rec.* 17949 (1967); and attorneys, accountants and business consultants. *Id.* at 17950. Both the accounting and insurance industries were specifically identified as being among those RICO was intended to reach. 116 *Cong. Rec.* 592 (1970).

#### D. The Litigation Floodgates Will Not Open as a Result of Adopting the Seventh Circuit's Construction of the Participation Element.

There need be no concern that an avalanche of civil RICO lawsuits will be filed if the Court adopts the Seventh Circuit's construction of "participate." Despite their success in RICO actions, insurance liquidators have been judicious in their resort to RICO. As to other RICO plaintiffs, the Seventh Circuit's construction of the participation element has been the law for more than a decade, and there is nothing to suggest that that circuit has experienced a disproportionate number of civil RICO filings.

In any event, "concern over the consequences of an unbridled reading of the [RICO] statute" is no excuse to restrict its breadth. *Sedima, S.P.R.L. v. Imrex Co.*, *supra* 473 U.S. at 481. And, in fact, very few plaintiffs have successfully pled RICO violations against outsiders to the identified enterprise, not because of defects in their allegations regarding "participation," but because of defects regarding other elements. For example, only a very few civil RICO cases naming independent auditors and attorneys as defendants have withstood motions to dismiss in recent years, and of those, half involved situations where some or all of the alleged co-schemers had pleaded guilty to criminal charges.<sup>17</sup> Most have been dismissed for

<sup>17</sup> Reported opinions in which some or all co-schemers had pleaded guilty to criminal fraud are: *Ikuno v. Yip*, 912 F.2d 306 (9th Cir. 1990) (reversing summary judgment in favor of the attorney for a "phantom" corporation, two of whose employees had pleaded guilty to fraudulent operation of the company); and *State Farm Mutual Auto Insurance Co. v. Rosenfield*, 683 F.Supp. 106 (E.D. Pa. 1988) (attorney and doctors, who pled guilty to criminal charges of defrauding an insurance company, denied summary judgment on civil RICO claims brought by the defrauded company).

(Footnote continued on following page)

deficiencies in the allegations of fraud,<sup>18</sup> pattern,<sup>19</sup> or enterprise.<sup>20</sup>

<sup>17</sup> continued

Civil RICO complaints against independent auditors and attorneys that have withstood motions to dismiss where co-schemers had not pled guilty are described in *Schacht v. Brown*, *supra* 711 F.2d 1343; *James v. Meinke*, 778 F.2d 200 (5th Cir. 1985) (affirming RICO jury verdict against CPA who gave clients false information when soliciting them to invest in enterprises in which he had an interest); *Gilmore v. Berg*, 761 F.Supp. 358 (D.N.J. 1991) (upholding RICO charges against attorney and accountant charged with knowingly distributing materially false information to investors in limited partnerships); *Gutfreund v. Christoph*, 658 F.Supp. 1378 (N.D.Ill. 1987) (RICO claims upheld against accountant who allegedly prepared and distributed false financial projections circulated as part of the offering materials for a limited partnership investment).

<sup>18</sup> *E.g.*, *Browning Avenue Realty Corp. v. Rosenshein*, 774 F.Supp. 129, 137-9 (S.D.N.Y. 1991); *Griffin v. McNiff*, 744 F.Supp. 1237, 1254-5 (S.D.N.Y. 1990); *Friedman v. Arizona World Nurseries Ltd.*, 730 F.Supp. 521, 545-6 (S.D.N.Y. 1990), *aff'd.*, 927 F.2d 594 (2nd Cir. 1991).

<sup>19</sup> *E.g.*, *Feinstein v. Resolution Trust Corp.*, 942 F.2d 34 (1st Cir. 1991) (attorney's representation of plaintiffs at 25 real estate closings over a period of four months insufficient to satisfy "continuity" prong of pattern requirement); *Hartz v. Friedman*, 919 F.2d 469 (7th Cir. 1990) (affirming dismissal of civil RICO pleadings against an attorney on "pattern" grounds and noting that the Seventh Circuit had not found patterns to exist in any civil RICO cases since this Court's decision in *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229 (1989)).

<sup>20</sup> *E.g.*, *Manar v. McNamara*, 842 F.2d 808 (5th Cir. 1988); *Bingham v. Zolt*, 683 F.Supp. 965 (S.D.N.Y. 1988) (*Turkette*-type enterprises involving attorneys, auditors and others held insufficient where there was no threat of continued illegal activity).

## CONCLUSION

The participation of independent entities and consultants is essential to the ongoing operation of an insurance company. When these entities and persons join with company management to commit a pattern of racketeering activity that defrauds the company and its policyholders, they should be held accountable. To let the very persons without which the RICO scheme could not have succeeded off the hook is bad statutory construction and bad policy. For all of the reasons stated above the decision of the Eighth Circuit should be reversed.

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Dated April 9, 1992.

8  
No. 91-886

FILED  
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# In The Supreme Court Of The United States

OCTOBER TERM, 1991

BOB REVES, ROBERT H. GIBBS,  
AND FRANCES GRAHAM, AS  
REPRESENTATIVES OF A CLASS OF  
NOTEHOLDERS,

*Petitioners,*

v.

ERNST & YOUNG

*Respondent.*

ON WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE EIGHTH CIRCUIT

BRIEF OF AMICUS CURIAE  
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IN THE  
SUPREME COURT OF THE UNITED STATES  
October Term, 1991

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No. 91-886

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BOB REVES, ROBERT H. GIBBS,  
and FRANCES GRAHAM, as  
representatives of a class of  
noteholders,  
Petitioners,

v.

ERNST & YOUNG,  
Respondent.

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On Writ of Certiorari  
to the United States Court of Appeals  
for the Eighth Circuit

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BRIEF OF AMICUS CURIAE  
TRIAL LAWYERS FOR PUBLIC JUSTICE, P.C.  
IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE

This brief is submitted on behalf of  
Trial Lawyers for Public Justice, P.C.

(TLPJ).<sup>\*</sup> It is submitted with the consent of both Petitioners and Respondent. TLPJ is a public interest law firm that represents victims of the abuse of power in our society. TLPJ selects its cases from among those that will advance the cause of justice, educate the public, modify corporate or government behavior, or improve the access of victims to the courts to remedy injustice. Supported by over 1200 lawyers in the United States and the world, it is the only public interest law firm in this Country dedicated to using civil remedies for the public good.

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<sup>\*</sup>The assistance in the preparation of this brief of Notre Dame law students Aileen M. Bigelow ('93), Edmond F. Foley ('92), David A. Haines ('93), Mary C. Kinsella ('92), Paul B. McCarthy ('93), Andrew M. McIlvaine ('93) and Lynne M. Pregenzer ('93) is hereby acknowledged.

Based on its experience with the statutes, TLPJ firmly believes that the Racketeer Influenced and Corrupt Organizations Act (RICO) and its state counterparts are among the few effective remedies available to victims of crime to obtain adequate legal redress, particularly when they are cheated by various forms of fraud. In this brief, TLPJ advocates a construction of "conduct" within federal RICO, not limited to manage or operate, that will maintain congressionally-mandated access to the federal courts and the adequate compensation provided to such victims in the remedial provisions of RICO, 18 U.S.C. §1964.

#### SUMMARY OF ARGUMENT

In 1970, Congress enacted P.L. 91-

452, the Organized Crime Control Act, Title IX of which is known as "RICO." This Court ought to adopt a straightforward definition of "conduct" within RICO, not limited to manage or operate, that reflects RICO's text, legislative history and policy. Professionals, including accountants and lawyers, should not be insulated from responsibility for their unlawful acts by an artificially restrictive construction of "conduct." In enacting RICO, Congress was concerned with various forms of criminal conduct, including fraud. Nothing that has happened since then undermines Congress' 1970 judgment. Financial fraud, in which professionals play a pivotal role, costs the Nation billions of dollars annually. It victimizes small businesses, savers, investors, homeowners, the elderly,

consumers, and federal, state, and local governments. Because attempts to restrict RICO judicially are rooted in false myths and are constitutionally improper, this Court should reject them.

- I. CONGRESS DELIBERATELY CRAFTED RICO AS A BROAD REMEDY FOR VICTIMS OF PATTERNS OF CRIMINAL CONDUCT INVOLVING ENTERPRISES.
  - A. RICO Provides a Critical Remedial Framework For Victims of Financial Fraud.

- 1. The Background of RICO.

In 1970, Congress enacted P.L. 91-452, the Organized Crime Control Act, Title IX of which is known as RICO.<sup>1</sup>

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<sup>1</sup> Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified as amended at 18 U.S.C. §§ 1961-68 (1988 & Supp. I. 1989)). See generally G. Robert Blakey & Thomas A. Perry, An Analysis of the Myths that Bolster Efforts to Rewrite RICO and the Various Proposals For Reform, 43 Vand. L. Rev. 851 (1990) (hereinafter "Myths"); G. Robert Blakey, The RICO Civil Fraud Action in Context: Reflections on Bennett v. Berg, 58 Notre

Title IX addresses "enterprise criminality"<sup>2</sup> involving fraud.<sup>3</sup>

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Dame L. Rev. 237 (1982) (hereinafter "Civil Fraud Action"); G. Robert Blakey & Scott Cessar, Equitable Relief Under Civil RICO, 62 Notre Dame L. Rev. 526 (1987) (hereinafter "Equitable Relief"); G. Robert Blakey & Brian Gettings, Racketeer Influenced and Corrupt Organizations (RICO): Basic Concepts--Criminal and Civil Remedies, 53 Temple L.Q. 1009 (1980) (hereinafter "Basic Concepts"). Three recent symposia are: Symposium: The 20th Anniversary of the Racketeer Influenced and Corrupt Organizations Act (1970-1990), 64 St. John's L. Rev. 701 (1990); Symposium: Reforming RICO: If, Why, and How?, 43 Vand. L. Rev. 621 (1990); and Symposium: Law and The Continuing Enterprise: Perspectives on RICO, 65 Notre Dame L. Rev. 872 (1990). Twenty-nine states have RICO-type legislation. Myths at 988-1011. See Morehead v. State, 383 So. 2d 629, 630-31 (Fla. 1980) (Florida RICO read in light of federal RICO).

<sup>2</sup> United States v. Cauble, 706 F.2d 1322, 1330 (5th Cir. 1983) ("'enterprise criminality'" consists of "all types of organized criminal behavior '[ranging] from simple political corruption to sophisticated white-collar crime schemes to traditional Mafia-type endeavors.'") (quoting Basic Concepts at 1013-14), cert. denied, 465 U.S. 1005

Congress, particularly concerned with "fraud,"<sup>4</sup> wanted to protect "innocent investors."<sup>5</sup> Because Congress found that "the sanctions and remedies available" were "unnecessarily limited in scope and impact,"<sup>6</sup> Congress enacted RICO to provide criminal and civil sanctions, including imprisonment, forfeiture, injunctions, and treble damage relief for "person[s] injured" in their "business or property" "by reason of" a violation of the statute.<sup>7</sup> "[T]he major purpose of [RICO was] to address the infiltration of

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(1984).

<sup>3</sup> Civil Fraud Action at 300-06 (analysis of RICO's various predicate offenses).

<sup>4</sup> 84 Stat. 922 (1970).

<sup>5</sup> Id. at 923.

<sup>6</sup> Id.

<sup>7</sup> 18 U.S.C. §§ 1963, 1964(c).

legitimate business by organized crime," but RICO was designed to reach both "illegitimate" and "legitimate" enterprises.<sup>8</sup> "[T]he notion that RICO is limited to organized crime [, however,] finds no support in the Act's text, and is at odds with the tenor of its legislative history...."<sup>9</sup> "Congress drafted RICO broadly enough to encompass a wide range of criminal activity...."<sup>10</sup> "[Legitimate business persons] enjoy neither an inherent incapacity for criminal activity nor immunity from its consequences."<sup>11</sup> Accordingly, RICO fits

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<sup>8</sup> United States v. Turkette, 452 U.S. 576, 590-91 (1981).

<sup>9</sup> H. J. Inc. v. Northwestern Bell Telephone Co., 492 U.S. 229, 244-48 (1988).

<sup>10</sup> Id. at 248-49.

<sup>11</sup> Sedima, S.P.R.L. v. Imrex Co., Inc., 473 U.S. 479, 499 (1985).

well into a traditional pattern of federal legislation enacted as general reform, aimed at a specific target, but not limited to the specific target.<sup>12</sup>

Congress directed that RICO "be liberally construed to effectuate its remedial purposes."<sup>13</sup> If RICO's language

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<sup>12</sup> See, e.g., United States v. Culbert, 435 U.S. 371, 373-74 (1978); Perrin v. United States, 444 U.S. 37, 46 (1979); United States v. Fabrizio, 385 U.S. 263, 265-67 (1966); Bell v. United States, 462 U.S. 356, 358-62 (1983); Caminetti v. United States, 242 U.S. 470, 485-90 (1917). See generally Equitable Relief at 529 n.13 (other cases collected); id. at 568 n.189 (similar drafting of Klu Klux Klan Act of 1871 and Sherman Antitrust Act of 1890); G. Robert Blakey, Definition of Organized Crime in Statutes and Law Enforcement Administration, in President's Comm. on Organized Crime, Report to The President And The Attorney General--The Impact: Organized Crime Today 511-80 (April 1986).

<sup>13</sup> 84 Stat. 922, 947 (1970).

is plain, it controls.<sup>14</sup> If its language, syntax, or context is ambiguous, the construction that would "effectuate its remedial purposes" "by providing enhanced sanctions and new remedies" is to be adopted.<sup>15</sup> Its language is to be read in the same fashion, whatever the character of the suit.<sup>16</sup>

"Congress [in enacting RICO] was

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<sup>14</sup> Turkette, 452 U.S. at 587 n.10; Russello v. United States, 464 U.S. 16, 29 (1983); Shearson American Express, Inc. v. McMahon, 482 U.S. 220, 239, reh'g denied, 483 U.S. 1056 (1987); United States v. Monsanto, 491 U.S. 600, 606 (1989); H.J. Inc., 492 U.S. at 249.

<sup>15</sup> 84 Stat. 922, 947 (1970); Turkette, 452 U.S. at 487-88, 593; Russello, 464 U.S. at 27; Sedima, 473 U.S. at 497-98; Monsanto, 491 U.S. at 609; Tafflin v. Levitt, 493 U.S. 455, 467, reh'g denied, 495 U.S. 915 (1990).

<sup>16</sup> Sedima, 473 U.S. at 489; Shearson, 482 U.S. at 239.

well aware that it was entering a new domain."<sup>17</sup> An issue was whether RICO should preempt other remedies. Congress, however, saved "provision[s] of federal, state, or other law imposing criminal penalties or affording civil remedies in addition to those provided for" in RICO.<sup>18</sup>

"Congress enacted RICO in order to supplement, not supplant, the available remedies since it thought those remedies offered too little protection for the

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<sup>17</sup> Turkette, 452 U.S. at 586.

<sup>18</sup> 84 Stat. 922, 947 (1970). Such clauses are a common feature of federal statutes. See, e.g., Securities Exchange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended at 15 U.S.C. §78bb(a) (1988)) ("rights and remedies" "in addition" to "any and all other rights" that exist).

victims."<sup>19</sup> Such overlap between statutes "is neither unusual nor unfortunate."<sup>20</sup> The existence of cumulative remedies furthers remedial purposes.<sup>21</sup>

2. Standards Of Unlawful Conduct Under RICO.

Title 18, United States Code, Section 1962, sets forth standards of "unlawful" conduct. Section 1963 sets out criminal penalties, and Section 1964 sets out civil remedies. RICO is not primarily criminal and punitive, but

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<sup>19</sup> Haroco, Inc. v. American Nat'l Bank & Trust Co. of Chicago, 747 F.2d 384, 392 (7th Cir. 1984), aff'd, 473 U.S. 606 (1985). See Michael Goldsmith, Civil RICO Reform, 71 Minn. L. Rev. 827, 840-48 (1987).

<sup>20</sup> SEC v. National Sec., Inc., 390 U.S. 453, 468 (1969).

<sup>21</sup> Herman & MacLean v. Huddleston, 459 U.S. 375, 386 (1983).

civil and remedial.<sup>22</sup>

a. Person.

Title 18, United States Code, Section 1961(3), in relevant part, provides:

(3) 'person' includes any individual or entity capable of holding a legal or beneficial interest in property....

b. Standards.

Title 18, United States Code,

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<sup>22</sup> Turkette, 452 U.S. at 592-93; Sedima, 473 U.S. at 497-98; Shearson, 482 U.S. at 238-42; Tafflin, 493 U.S. at 467 (citing Sedima). Statutory classifications control over federal common law classifications. City of Milwaukee v. Illinois, 451 U.S. 304, 312-15 (1982). Such statutory classifications are entitled to great deference. United States v. One Assortment of 89 Firearms, 465 U.S. 354, 365 (1984). See also 115 Cong. Rec. 6993 (1969) (Stat. of Sen. Hruska) ("[T]he criminal provisions are intended primarily as an adjunct to the civil provisions which I consider as the more important feature of the bill."); 116 Cong. Rec. 602 (1970) (Stat. of Sen. Hruska) ("the principal value of this legislation may well be found to exist in its civil provisions").

Section 1962(c), in relevant part, provides:

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in ... interstate ... commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity ... (emphasis added).

Like the antitrust statutes,<sup>23</sup> RICO's civil provisions "create a private enforcement mechanism that...deter[s] violators....[and] provide[s] ample

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<sup>23</sup> S. Rep. No. 617, 91st Cong., 1st Sess. 81, 157-61 (1969); H.R. Rep. No. 1549, 91st Cong., 2d Sess. 56-60 (1970). RICO and the antitrust statutes are well integrated. "There are three possible kinds of force which a firm can resort to: violence (or threat of it), deception, or market power." Carl Kaysen & Donald Turner, Antitrust Policy 17 (1959). RICO focuses on the first two; antitrust laws focus on the third. See also American Column Lumber Co. v. United States, 257 U.S. 377, 414 (1921) (Brandeis, J., dissenting) ("Restraint may be exerted through force or fraud or agreement.").

compensation to the victims."<sup>24</sup> RICO's treble damage provisions "provide strong incentives to civil litigants and are integral to the effort of Congress to enlist the aid of civil claimants in deterring" violations of RICO.<sup>25</sup> Such "private...litigation is one of the surest weapons for effective enforcement"<sup>26</sup> of the law; it "provide[s] a significant supplement to the limited resources available to [the government]".<sup>27</sup>

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<sup>24</sup> Blue Shield of Virginia v. McCready, 457 U.S. 465, 472 (1982).

<sup>25</sup> Alcorn County v. U.S. Interstate Supplies, Inc., 731 F.2d 1160, 1165 (5th Cir. 1984).

<sup>26</sup> Leh v. General Petroleum Corp., 382 U.S. 54, 59 (1965) (quoting Minnesota Mining & Mfg. Co. v. New Jersey Wood Finishing Co., 381 U.S. 311, 318 (1965)), reh'g denied, 382 U.S. 1001 (1966).

<sup>27</sup> Reiter v. Sonotone Corp., 442 U.S. 330, 344 (1979). In fact, between 1960 and 1980, of the 22,585 civil and

B. The Eighth Circuit Adopted A Restrictive Construction of "Conduct" Under RICO That is Inconsistent with RICO's Plain Meaning, P.L. 91-452 as a Whole, the Congressional Mandate That RICO Be Liberally Construed, and Congress' Own Understanding of RICO.

Following the dictum in its prior decision in Bennett v. Berg,<sup>28</sup> the Eighth Circuit held in the instant litigation that "conduct" within RICO "ordinarily

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criminal cases brought under the antitrust provisions by the government or private parties, 85% were instituted by private plaintiffs. U.S. Department of Justice, Source Book on Criminal Justice Statistics 431 (1981). Professor (now Judge) Posner also argues forcefully on economic grounds for private enforcement of more than actual damages awards against all forms of deliberate antisocial conduct, particularly where the factor of concealment is present. Richard Posner, Economic Analysis of Law 462 (private enforcement), 143, 272 (more than actual damage awards, for deliberate conduct), 235 (concealment) (2d ed. 1977). On the history and economic rationale of treble damages, see Equitable Relief at 530 n.17.

<sup>28</sup> 710 F.2d 1361, 1364 (8th Cir.) (en banc), cert. denied, 464 U.S. 1008 (1983).

will require some participation in the operation or management of the enterprise itself." 937 F.2d 1310, 1324, cert. granted, 60 U.S.L.W. 3578 (U.S. Feb. 24, 1992) (No. 91-886). Auditing, meeting with a board of directors to explain the audits, and presentations at annual meetings, does not, the Court held, constitute such operation or management. 937 F.2d at 1324. As such, the Eighth Circuit--consistent with the D.C. Circuit and earlier, but no longer controlling, Fourth Circuit precedent, and in opposition to precedent in the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits--continued to follow its own "restrictive view."<sup>29</sup>

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<sup>29</sup> See Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639, 913 F.2d 948, 952-95 (D.C. Cir. 1990) (en banc) ("most restrictive") (review of 2d, 4th, 5th, 7th and 11th Cir. precedent), cert. denied, 111 S. Ct.

1. A Restrictive Construction of "Conduct" Is Inconsistent With RICO's Plain Meaning.

While the interpretation of RICO begins with the plain language of its text, structure, legislative history, and congressional policy are also important.<sup>30</sup> "Person," which defines who

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2839 (1991); United States v. Provenzano, 688 F.2d 194, 200 (3d Cir.), cert. denied, 459 U.S. 1071 (1982); United States v. Webster, 639 F.2d 174, 185 (4th Cir. 1981) (earlier manage or operate test no longer controlling), modified on other grounds, 669 F.2d 185 (4th Cir.), cert. denied, 456 U.S. 935 (1982); United States v. Gaoud, 777 F.2d 1105, 1116 (6th Cir. 1985), cert. denied, 475 U.S. 1098 (1986); Blake v. Diedorff, 856 F.2d 1365, 1372 (9th Cir. 1988).

<sup>30</sup> This Court in Turkette, Russello, Sedima, Agency Holding Corp. v. Malley-Duff & Assoc., 483 U.S. 143 (1987) Shearson, Caplin & Drysdale v. United States, 491 U.S. 617 (1989), Monsanto, Tafflin, H.J. Inc. and SIPC v. Holmes, No. 90-727 decided March 24, 1992, established the basic principles that govern RICO:

(1) read the language of the statute (Turkette, 452 U.S. at 580, 593; Russello, 464 U.S. at 20 (citing Turkette); Sedima, 473 U.S.

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at 495 n.13; Shearson, 482 U.S. at 227; Monsanto, 491 U.S. at 606 (citing Turkette); H.J. Inc., 492 U.S. at 237 (citing Russello));

(2) language includes its structure (Turkette, 452 U.S. at 582, 587; Russello, 464 U.S. at 22-23; Sedima, 473 U.S. at 490 n.8, 496 n.14; Agency Holding Corp., 483 U.S. at 152);

(3) language should be read in its ordinary or plain meaning, but must be viewed in context (Turkette, 452 U.S. at 580, 583 n.5, 587; Russello, 464 U.S. at 20 (citing Turkette), 21-23, 25; Sedima, 473 U.S. at 495 n.13; H.J. Inc., 492 U.S. at 238 (citing Richards v. United States, 369 U.S. 1, 9 (1962)));

(4) language should not be read differently in criminal and civil proceedings (Sedima, 473 U.S. at 489, 492; Shearson, 482 U.S. at 239-40) (citing Sedima));

(5) look to the legislative history of the statute (Turkette, 452 U.S. at 586, 589; Sedima, 473 U.S. at 486, 489; Shearson, 482 U.S. at 238-41; Agency Holding Corp., 483 U.S. at 151; Monsanto, 491 U.S. at 613; H.J. Inc., 492 U.S. at 236-39 (citing Sedima); Tafflin, 493 U.S. at 464);

(6) look to the policy of the statute (Turkette, 452 U.S. at 590; Russello, 464 U.S. at 24; Sedima, 473 U.S. at 493; Tafflin, 493 U.S. at 467);

may violate RICO, includes "any individual or entity." 18 U.S.C. § 1961(3). "Any" means "all", not "some,

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(7) the statute was aimed at the infiltration of legitimate business by organized crime (Turkette, 452 U.S. at 591; Russello, 464 U.S. at 27, 28 (citing Turkette); Caplin & Drysdale, 491 U.S. at 630; H.J. Inc., 492 U.S. at 245 (citing Russello and Turkette));

(8) the statute was not limited to the infiltration of legitimate business by organized crime (Turkette, 452 U.S. at 590-91; Russello, 464 U.S. at 28; Sedima, 473 U.S. at 495, 499; H.J. Inc., 492 U.S. at 242-49 (citing Sedima));

(9) the statute is to be broadly read and liberally construed (Turkette, 452 U.S. at 587, 593; Russello, 464 U.S. at 21; Sedima, 473 U.S. at 491-92 n.10, 497-98; Monsanto, 491 U.S. at 609 (citing Sedima); H.J. Inc., 492 U.S. at 237; Tafflin, 493 U.S. at 467 (citing Sedima)); and

(10) the civil enforcement mechanism of the statute was modeled on the similar provision of the antitrust laws (Sedima 473 U.S. at 489; Shearson 482 U.S. at 241; Agency Holding Corp., 483 U.S. at 150-51; SIPC, slip opinion at 7).

but not others."<sup>31</sup> No distinction is made between "insiders" or "outsiders."<sup>32</sup> Inculcation under RICO is not limited to "mobsters." Sedima, 473 U.S. at 495 ("not just mobster"). White-collar professionals, too, are not to be automatically exculpated.<sup>33</sup>

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<sup>31</sup> Mobil Oil Exploration v. United Distribution Co., 111 S. Ct. 615, 623 (1991) (since "'any' encompasses 'all'...the statute is clear and unambiguous [and] that is the end of the matter..." (citing Sullivan v. Stroop, 110 S. Ct. 2499, 2502 (1990) (quoting K-Mart Corp. v. Cartier, Inc., 486 U.S. 281, 291 (1988))).

<sup>32</sup> See, e.g., Schacht v. Brown, 711 F.2d 1343, 1360 (7th Cir.) ("the RICO net is woven tightly to trap even the smallest fish") (quoting United States v. Elliot, 571 F.2d 880, 903 (5th Cir.), cert. denied, 439 U.S. 953 (1978)) (accountants liable in insurance fraud), cert. denied 464 U.S. 1002 (1983).

<sup>33</sup> See, e.g., Furman v. Cirrito, 741 F.2d 524, 529 (2nd Cir.) (RICO includes "no exception for businessmen, for white-collar workers, for bankers, or for stockbrokers") (Pratt, J.), vacated in part on other grounds, 473 U.S. 922 (1985).

The language "to conduct or participate, directly or indirectly, in the conduct of...[an] enterprise's affairs" is easily understood as a matter of plain meaning. As such, "[t]here is no warrant for seeking refined arguments to show that the statute does not mean what it says." United States v. Wurzbach, 280 U.S. 396, 398 (1930) (Holmes, J.). The key distinction is in the use of "conduct" in the relevant language as a verb ("to conduct") and as a noun ("conduct"). Conduct as a verb is defined as "[t]o manage; direct; lead; have direction, carry on; regulate; do business." Black's Law Dictionary 367 (4th ed. 1957). Conduct as a noun, however, is defined as "[p]ersonal behavior; deportment; mode of action; any

positive or negative act." Id.<sup>34</sup> In the relevant language, "to conduct" is then stated in the disjunctive ("or") with "participate," which is, in turn, defined as "to receive or have a part or share of; to partake of; experience in common with others; to have or enjoy a part or share in common with others; partake; as to 'participate' in a discussion. To take a part in; as to participate in joy

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<sup>34</sup> See also The Compact Edition of Oxford English Dictionary 508 (1971) ("The notion of direction or leadership is often obscured or lost; e.g., an investigation is conducted by all those who take part in it"); Webster's Seventh New Collegiate Dictionary 173 (1970) ("2. management... 3....personal behavior"); Webster's New Dictionary of Synonyms 174 (1971) ("conduct may imply the act of an agent who is both the leader and the person responsible for the acts and achievements of a group...but often the idea of leadership is lost or obscured and the stress is placed on a carrying on by all or by many of the participants....").

or sorrows." Id. at 1275.<sup>35</sup>

As such, while "conduct" as a verb ("to conduct") may mean management, direction, etc., Congress manifestly intended to cast a wider net, since it added to "to conduct" in the disjunctive ("or") "[to] participate directly or indirectly." See Russello, 464 U.S. at 21 ("RICO...utilize[s] terms and concepts of breadth [,including] 'participate'"). Clearly, too, "conduct" in the relevant language ("the conduct of") is used as a noun. As such, it means "behavior, deportment, mode of action, etc." If it is read to mean "management," its placement in the sentence becomes superfluous. The sentence would read "to

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<sup>35</sup> See also "particeps criminis," which is Latin for "participant in a crime; an accomplice." Black's Law Dictionary 1274 (4th ed. 1957).

manage...in the management of." While if it means "behavior," the sentence would--more plausibly--read "to manage...in the behavior, deportment, or mode of action of." Plain meaning, therefore, belies the Eighth Circuit's construction of RICO. As such, its restrictive--and superfluous--reading ought not be adopted by this Court.<sup>36</sup>

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<sup>36</sup> It is not the law in comparable provisions. "Conduct" and "control" are synonyms. Webster's New Dictionary of Synonyms 174 (1971). Section 20 of the Securities Exchange Act of 1934, 48 Stat. 881, 899 (codified as amended at 15 U.S.C. § 78 t[a] (1988)) ("directly or indirectly controls"), however, extends to accountants. Sharp v. Coopers & Lybrand, 649 F.2d 175, 185 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982), overruled on other grounds; In Re Data Access Securities Litig., 843 F.2d 1537 (3d Cir. 1988). See also Commerford v. Olson, 794 F.2d 1319, 1322 (8th Cir. 1986) (Sharp followed).

If "conduct" within RICO were restricted to manage or operate, it could, moreover, lead to a management only rule. Compare United States v. Pino-Perez, 830 F.2d 1230, 1237 (7th Cir.) (en banc) (principal in the second

2. A Restrictive Construction of "Conduct" Within RICO Is Inconsistent with P.L. 91-452 As A Whole.

Repeatedly, this Court has read P.L. 91-452 as a whole. Iannelli v. United States,<sup>37</sup> (Title VIII (gambling) read in light of Title X (dangerous special

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degree liability possible under 21 U.S.C. § 848 (CCE or Drug Kingpin statute)), cert. denied, 493 U.S. 901 (1989) with United States v. Amen, 831 F.2d 373, 381-82 (2nd Cir. 1987) (liability under § 848 limited to principal in the first degree), cert. denied, 485 U.S. 1021 (1987). RICO then would be eviscerated as an effective weapon against criminal groups, for unlike CCE, RICO's predicates include state offenses; a failure to convict under RICO might well lead to a failure to convict at all. RICO ought not to be so hobbled. See generally Federal Government's Use of The RICO Statute and Other Efforts Against Organized Crime, S. Rep. No. 101-407, 101st Cong., 2nd Sess. 31-36 (1990) (RICO effective against organized crime); Wayne R. LaFave and Austin W. Scott, Jr. Criminal Law § 6.8(c) (2d ed. 1986) (person who may not directly commit an offense may be convicted as accomplice).

<sup>37</sup> 420 U.S. 770, 786-91 (1975), overruled on other grounds. Brown v. Ohio, 432 U.S. 161 (1977).

offender)); Sedima, 473 U.S. at 489 n.7. (Title IX RICO read in light of Title X (dangerous special offender)); H.J. Inc., 492 U.S. at 239-40 (Title IX (RICO) read in light of Title X (dangerous special offender)) ("[W]e may take guidance from a provision elsewhere in...P.L. 91-452"). As P.L. 91-452 is "a carefully crafted piece of legislation," Iannelli, 420 U.S. at 789, here, too, this Court's task is made easier if it looks to Title VIII (18 U.S.C. §§ 1511, 1955) and Title X (18 U.S.C. §§ 3575, 3577). These other provisions enacted by P.L. 91-452 show Congress' intent in Title IX.

18 U.S.C. § 1511(a), in relevant part, provides:

It shall be unlawful...to conspire to obstruct the enforcement of the criminal laws of a State...with the

intent to facilitate an illegal gambling business if--

xxx

(3) one or more of such persons conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business (emphasis added).

18 U.S.C. § 1955(a), in relevant part, provides:

Whoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be....(emphasis added).<sup>38</sup>

This Court--and the prevailing view among the circuits--holds that "conduct" in 18 U.S.C. §§ 1511 and 1955 is to be

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<sup>38</sup> See S. Rep. No. 617, 91st Cong., 1st Sess. 155 (1969) ("officials covered by [Senate passed text of §§ 1511, 1955] are not to be artificially limited, and participation...is to be understood comprehensively"); H. Rep. No. 1549, 91st Cong., 2d Sess. 53 (1970) ("The term 'conducts' [in the enacted texts of §§ 1511, 1955] refers both to high level bosses and street level employees.").

read without an artificial restriction.

See, e.g., Sanabria v. United States, 437

U.S. 54, 70 n.26 (1978) ("conduct"

proscribes "any degree of participation in an illegal gambling business"); United

States v. Zannino, 895 F.2d 1, 10 (1st

Cir.), cert. denied, 494 U.S. 1082

(1990).<sup>39</sup> Similarly worded statutes in

pari materia should receive a similar

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<sup>39</sup> Significantly, when the Fifth Circuit in Bank of America Nat'l Trust & Sav. Ass'n v. Touche Ross & Co., 782 F.2d 966, 970 (11th Cir. 1986) rejected, in civil litigation under RICO, the manage or operate test for "conduct," it properly relied on its prior decision in United States v. Martino, 648 F.2d 367, 382 (5th Cir. 1981), aff'd on other grounds, 464 U.S. 16 (1983), a criminal prosecution, which, in turn, relied upon United States v. Tucker, 638 F.2d 1292, 1295-96 (5th Cir.) (waitress who serves drinks conducts illegal gambling business under 18 U.S.C. § 1955, since her services are "necessary or helpful" to the operation of the enterprise), cert. denied, 454 U.S. 833 (1981). The Fifth Circuit's reading of "conduct" in RICO in light of "conduct" in § 1955 was principled. This Court should do no less.

construction. SIPC, slip opinion at 8-9 ("by reason of" in Section 1964(C) read in light of "by reason of" in §4 of the Clayton Act).<sup>40</sup>

18 U.S.C. § 3575(c), in relevant part, as enacted in 1970 as part of Title X of P.L. 91-452, but now repealed, then provided:

A defendant is a special offender...if--

- (1) xxx (recidivist provisions)
- (2) the defendant committed such felony as part of a pattern of conduct...in which he manifested special skill or expertise; or
- (3) such felony was, or the defendant committed such felony in furtherance of, a conspiracy...to engage in a pattern of conduct..., and the

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<sup>40</sup> See also Erlenbaugh v. United States, 409 U.S. 239, 243 (1972); United States v. Stewart, 311 U.S. 60, 64-65 (1940).

defendant did, or agreed that he would, initiate, organize, plan, finance, direct, manage, or supervise all or part of such conspiracy or conduct, or give or receive a bribe or use force as all or part of such conduct (emphasis added).<sup>41</sup>

18 U.S.C. § 3577, as enacted in 1970 as part of Title X of P.L. 91-452, but now repealed, then provided:

No limitation shall be placed on the information

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<sup>41</sup> See S. Rep. No. 617, 91st Cong., 1st Sess. 164-65 (1969) ("Paragraph (2)...is designed to deal with the professional offender, who may neither be a recidivist nor play a leadership role.... The circumstance of the conduct itself must demonstrate that the offender is a professional possessing special skill or expertise.... The phrase 'skill or expertise' is meant broadly....xxx Paragraph (3)...is designed to deal...with...[t]hose who personally play or are to play leadership roles...."); H.R. Rep. No. 1549, 91st Cong., 2d Sess. 61-62 (1970) ("Paragraph (2)...is designed to deal with the professional offender, who may neither be a convicted recidivist nor play a leadership role....xxx Paragraph (3)...is designed to deal primarily with...[t]hose who personally play...leadership roles....").

concerning the background, character, and conduct of a person convicted of an offense which a court of the United States may receive and consider for the purpose of imposing an appropriate sentence (emphasis added).

Chief Justice John Marshall made the point more than one hundred years ago:

"[A] law is the best expositor of itself."<sup>42</sup> Clearly, Congress used "conduct" primarily in the sense of "behavior" in the provisions it added to Title 18 by P.L. 91-452. When it wanted to restrict its focus to particular aspects of participation in such behavior, it chose appropriate language. Had Congress intended "manage or operate" each time it used "conduct" in the statute, it would have said it. Sedima, 473 U.S. at 489; Russello, 464 U.S. at

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<sup>42</sup> Pennington v. Coxe, 6 U.S. (2 Cranch) 34, 52 (1804).

23; Turkette, 452 U.S. at 581.<sup>43</sup>

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<sup>43</sup> Throughout the United States Code, when Congress creates criminal or civil liability for those who hold positions of management, it consistently uses a form of the word "manage." See, e.g., 21 U.S.C. §848 (1991) (CCE) ("a person is engaged in a continuing criminal enterprise if...such person occupies a position of organizer, a supervisory position, or other position of management") (emphasis added); Garrett v. United States, 471 U.S. 773, 781 (1985) ("This language is designed to reach the 'top brass' in the drug rings, not the lieutenants and foot soldiers.") See also Edward J. Devitt & Charles B. Blackmar, Federal Jury Practice & Instructions §55.07 (1990) ("The term 'organizer' and the terms 'supervisory position' and 'position of management' are to be given their usual and ordinary meanings. These words imply the exercise of power or authority by a person who occupies some position of management or supervision.") See also 18 U.S.C. §1952 (1991) ("Whoever travels in interstate commerce with intent to...otherwise promote, manage, establish, carry on, or facilitate the promotion, management, establishment, or carrying on, of any unlawful activity...") (emphasis added). Despite the specific use of the word "manage" in §1952, courts, however, consistently interpret the phrase "promote, manage, establish, carry on, or facilitate" to mean "any act that would cause the 'unlawful activity' described in the indictment to be accomplished or

3. A Restrictive Construction of Conduct Within RICO Is Inconsistent With The Congressional Mandate That RICO Be Liberally Construed.

RICO must be "liberally construed to effectuate its remedial purposes."<sup>44</sup>

to assist the 'unlawful activity' in any way." See, e.g., U.S. v. Markowski, 772 F.2d 358, 364 (7th Cir. 1985), cert. denied, 475 U.S. 1018 (1986). See also Devitt & Blackmar, supra at §46.05. Other Title 18 offenses are construed similarly. See, e.g., 18 U.S.C. §1956 (1991) ("conduct...financial transactions"); United States v. Skinner, 946 F.2d 176, 178 (2d Cir. 1991) (broad construction). A similar use of "conduct" is made in the Sentencing Guidelines. See, e.g., U.S.S.G. §1B1.3 ("relevant conduct" means "acts or omissions"); U.S.S.G. §4B1.3 ("pattern of criminal conduct" means "planned criminal acts occurring over a substantial period of time. Such acts may involve a single course of conduct or independent offenses.") Restricting "conduct" within RICO would be inconsistent, therefore, with "conduct" usage throughout the Code. Ironically, these other statutes are not necessarily supposed to be liberally construed.

<sup>44</sup> 84 Stat. 922, 947 (1970). See Equitable Relief at 532 n.21 (origin of clause traced to work of Edward Livingston between 1820 and 1825).

Turkette, 452 U.S. at 593 ("both preventive and remedial")<sup>45</sup> The Eighth

Judicial hostility to change through legislation was common in the nineteenth century. James W. Hurst, The Growth of American Law 186 (1950). It became standard practice in drafting statutes to insert a preamble stating broadly the purpose of the act and to close with a provision declaring that the statute should be liberally construed. David Wigdor, Roscoe Pound: Philosopher of Law 174 (1974). In fact, a majority of states have abolished the common law rule of strict construction. Civil Fraud Action at 245 n.25. See also id. at 288 n.150 (analysis of relation between rules of construction, including rule of lenity, and Liberal Construction Clause).

<sup>45</sup> Circuit courts faithfully follow the liberal construction mandate in criminal litigation. See, e.g., United States v. Angiulo, 897 F.2d 1169, 1216 (1st Cir.), cert. denied, 111 S. Ct. 130 (1990); United States v. Mazzei, 700 F.2d 85, 89-90 (2d Cir.), cert. denied, 461 U.S. 945 (1983); United States v. Frumento, 563 F.2d 1083, 1090-91 (3d Cir. 1977), cert. denied, 434 U.S. 1072 (1978); In re Billman, 915 F.2d 916, 921 (4th Cir.), cert. denied, 111 S. Ct. 2258 (1991); United States v. Elliott, 571 F.2d 880, 897-98 (5th Cir.), cert. denied, 439 U.S. 953 (1978); United States v. Sutton, 642 F.2d 1001, 1003 (6th Cir. 1980), cert. denied, 453 U.S. 912 (1981); United States v. Grzywacz,

Circuit did not seek to justify its adoption of the manage or operate test in the teeth of RICO's Liberal Construction Clause. Candidly, the D.C. Circuit in Yellow Bus recognized that the Eighth Circuit's position was "the most restrictive view." 913 F.2d at 953. The D.C. Circuit then sought to justify its adoption of the illiberal view, however, by reference to dictionary meaning (id. at 954) and strict construction (id. at 955). Neither supports its position.

When it cited the dictionary, the D.C. Circuit unjustifiably ignored an

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603 F.2d 682, 685-86 (7th Cir. 1979), cert. denied, 446 U.S. 935 (1980); United States v. Godoy, 678 F.2d 84, 86-87 (9th Cir. 1982), cert. denied, 464 U.S. 959 (1983); United States v. Hartley, 678 F.2d 961, 988 (11th Cir. 1982), cert. denied, 459 U.S. 1170 (1983); and United States v. Perholtz, 842 F.2d 343, 353 (D.C. Cir.), cert. denied, 488 U.S. 821 (1988). This Court should do no less.

alternative--and more plausible--meaning set out in the same source. See Webster's Third New International Dictionary 473 (1961) ("behavior"). The rule of strict construction, too, did not warrant the D.C. Circuit's adoption of the "narrowest meaning." Turkette, 452 U.S. at 587-88 n.10 ("not an inexorable command to override common sense and evident statutory purpose. xxx [Strict construction] is satisfied if the words are given their fair meaning in accord with the manifest intent of the lawmakers.") (quoting United States v. Brown, 333 U.S. 18, 25-26 (1948)). The D. C. Circuit, in short, conflated breadth, ambiguity, and vagueness. As such, it confused the kind of uncertainty of application that stems from breadth of meaning caused by the use of broad terms, the kind of uncertainty of application

that stems from multiplicity of meaning caused by ambiguity, and the kind of impossibility of application that stems from vagueness caused by the use of terms having no meaning.<sup>46</sup>

RICO is neither ambiguous nor vague; it is broad. Sedima, 473 U.S. at 499 (citing Haroco at 398) (RICO "demonstrates breadth," not "ambiguity."). See also H.J. Inc., 492 U.S. at 237 ("terms and concept of breadth") (citing Russello, 464 U.S. at 21).

The strict construction rule,

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<sup>46</sup> See Reed Dickerson, Fundamentals of Legal Drafting 22-33 (1965) (analysis of "major diseases of language:" generality, ambiguity and vagueness); G. Robert Blakey, Is Pattern Void for Vagueness?, 5 Civil RICO Report 6, 9 n.27 (Dec. 12, 1989).

moreover, has no proper application to RICO in light of the Liberal Construction Clause. The rule is merely "a principle of statutory construction."<sup>47</sup> It is not a constitutional requirement.<sup>48</sup> As such, subject to the constitutional void-for-vagueness doctrine, Congress may abrogate it.<sup>49</sup> Absent first amendment considerations, not present in this litigation, a statute--RICO included--must be judged, as applied, not on its

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<sup>47</sup> United States v. Batchelder, 442 U.S. 114, 121 (1979). See also Turkette, 452 U.S. at 588; Russello, 464 U.S. at 29 (citing Turkette); Sedima, 473 U.S. at 492 n.10.

<sup>48</sup> See, e.g., Tarrant v. Ponte, 751 F.2d 459, 466 (1st Cir. 1985).

<sup>49</sup> See generally Civil Fraud Action at 245 n.25 (rule analyzed and statutes collected); 288 n.150 (liberal and strict construction compared with void-for-vagueness doctrine); G. Robert Blakey, Foreword: Debunking RICO's Myriad Myths, 64 St. John's L. Rev. 701, 718-19 (1990) (collection of void-for-vagueness precedents).

face.<sup>50</sup> Here, the accountants, who engaged in "a number of reprehensible acts," 937 F.2d at 1324, can hardly be heard to complain in "surprised innocence" when their behavior is found to violate RICO.<sup>51</sup>

#### 4. A Restrictive Construction of Conduct Within RICO Is Inconsistent With Congress' Own Understanding of RICO.

The "views of a subsequent Congress

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<sup>50</sup> See, e.g., Village of Hoffman Estates v. Flipside Hoffman Estates, Inc., 455 U.S. 489, 495 n.7 (1982).

<sup>51</sup> United States v. Ragen, 314 U.S. 513, 523-24 (1942) ("surprised innocence"). If the predicate offenses, are "not unconstitutionally vague, [then RICO]...cannot be vague either." Fort Wayne Books Inc., v. Indiana, 489 U.S. 46, 65-58 (1989); United States v. Masters, 924 F.2d 1362, 1367 (7th Cir.) (RICO constitutional as applied) (violation of RICO rather than predicate offense "a detail"), cert. denied, 111 S. Ct. 2019 (1991); S. Rep. No. 617, 91st Cong., 1st Sess. 158 (1969) (notice stems from predicate acts).

form a hazardous basis for inferring the intent of an earlier one."<sup>52</sup> "[S]tatutes are construed by the courts with reference to the circumstances existing at the time of the passage."<sup>53</sup> Nevertheless, subsequent legislative developments, which "confirm"<sup>54</sup> a construction of "conduct" in RICO that is not limited to manage or operate and which would not exclude professionals, are entitled to "significant weight."<sup>55</sup>

Efforts to "reform" RICO after

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<sup>52</sup> Russello, 464 U.S. at 26 (quoting Jefferson County Pharmaceutical Ass'n v. Abbott Lab., 460 U.S. 150, 165 n.17 (1983)).

<sup>53</sup> United States v. Wise, 370 U.S. 405, 411 (1962).

<sup>54</sup> See Andrus v. Shell Oil Co., 446 U.S. 657, 666 n.8 (1980).

<sup>55</sup> Seatrain Shipbuilding Corp. v. Shell Oil Co., 444 U.S. 572, 596 (1980).

Sedima properly focused on Congress.<sup>56</sup> Bar associations<sup>57</sup> and the accounting profession<sup>58</sup> played leading roles. A major effort was made to exempt professionals.<sup>59</sup> Writing special rules for one group, however, is

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<sup>56</sup> See, e.g., Oversight on Civil RICO Suits: Hearings before the Sen. Comm. on the Judiciary, 99th Cong., 1st Sess. (1985) (hereinafter "1985 Hearings").

<sup>57</sup> See, e.g., id. at 579 (testimony of Arthur F. Mathews in behalf of Ad Hoc Civil RICO Task Force of Am. Bar Ass'n) (high-level managerial agent limitation should be adopted).

<sup>58</sup> See, e.g., id. at 243 (testimony of Ray J. Groves in behalf of American Institute of Certified Public Accountants).

<sup>59</sup> See, e.g., RICO Reform Act of 1989: Hearings before the Subcomm on Crime of the House Judiciary Comm., 101st Cong., 1st Sess. 455 (1989) (testimony of Robert L. Chiesa on behalf of Am. Bar Ass'n) ("conduct" should require "policy making power" to "insulate accountants").

controversial.<sup>60</sup> The proposed reform now pending in Congress does not provide special rules for special groups.<sup>61</sup> The accounting profession ought not now obtain, therefore, in this judicial forum, a limitation on RICO that it was not successful in obtaining in the political forum.

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<sup>60</sup> See, e.g., 134 Cong. Rec. E3720 (daily ed. Oct. 21, 1988) (Stat. of Rep. John Conyers, Jr.) ("I see no reason to give the likes of Boesky or Butcher in their stock fraud or bank fraud activities a special bill of relief.").

<sup>61</sup> H.R. Rep. No. 312, 102d Cong., 1st Sess. 7, 15 (1991) (reporting H.R. 1717) (Prior legislation rejected because it "would go too far in certain respects and give the appearance of favoring certain industries, such as the commodities, securities and savings and loan industries which are currently the subject of major fraud investigations; no limit on "conduct" adopted; "major participant" screen for "gatekeeper" approach "creates no special protection for any group....[A]ccountants, lawyers and investment bankers....will still be liable....").

II. A RESTRICTIVE CONSTRUCTION OF CONDUCT WITHIN RICO WOULD UNJUSTIFIABLY INSULATE FROM LEGAL RESPONSIBILITY MANY PIVOTAL PARTICIPANTS IN DEVASTATING SCHEMES TO DEFRAUD.

Article III of the Constitution does not grant a court power to redraft legislation because of its "appraisal of the wisdom and unwisdom of a particular [legislative] course...."<sup>62</sup> Nevertheless, an examination of the considerations implicated by Congress' action in 1970 is required by this Court's jurisprudence that plain meaning may be departed from to avoid absurd or surprising results.<sup>63</sup> The broad language

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<sup>62</sup> Diamond v. Chakrabarty, 447 U.S. 303, 318 (1980) (quoting TVA v. Hill, 437 U.S. 153, 194 (1978)). See also Airline Pilots Ass'n Int'l v. O'Neill, 111 S. Ct. 1127, 1135 (1991).

<sup>63</sup> See, e.g., United States v. Ryan, 284 U.S. 167, 175-76 (1931) (civil forfeiture provision narrowed to give it

chosen by Congress in RICO, however, is "neither absurd nor surprising."<sup>64</sup>

The controversy over RICO does not primarily center on its criminal provisions or its possible civil application in the areas of violence, the provision of illicit goods and services, or the corruption of unions and governmental entities. Instead, it focuses almost exclusively on the commercial fraud area. In 1970, however, Congress focused RICO on "fraud." 84

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"a sensible construction").

<sup>64</sup> Turkette, 452 U.S. at 587. See also In Re Rouse, 221 N.Y. 81, 91, 116 N.E. 782, 785 (1917) (Cardozo, J.) ("consequences cannot alter statutes but may help to fix their meaning"), cert. denied, 246 U.S. 661 (1918). RICO sponsors, too, had professionals in mind. See Civil Fraud Action at 254 nn. 48 & 50 and 270 n.98. Such comments are a "weighty gloss." Galvan v. Press 347 U.S. 522, 527 (1954).

Stat. 922. It found that traditional "sanctions and remedies" were "unnecessarily limited in scope and impact." Id. at 923. It was well aware, in short, that "existing law, state and federal, was not adequate...." Turkette, 452 U.S. at 586. While almost two decades have passed since RICO became law, the task of controlling fraud remains formidable. "White-collar crime is 'the most serious and all-pervasive crime problem in America today.'"<sup>65</sup> Although this statement was made in 1980, there is no reason to think the problem has diminished in the meantime.

In 1974, the Chamber of Commerce

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<sup>65</sup> Braswell v. United States, 487 U.S. 99, 115 n.9 (1988) (quoting Hon. John Conyers, Jr., Corporate and White-Collar Crime, 17 Am. Crim. L. Rev. 287, 288 (1980)).

estimated the direct economic cost of fraud as \$41.78 billion annually.<sup>66</sup> Given the inflation rate since the 1974 study, fraud likely costs society a figure more than four times that amount today.<sup>67</sup> The Chamber of Commerce study, moreover, did not account for the entire impact of fraud. White-collar crime has a "serious influence on the social fabric, and on the freedom of commercial

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<sup>66</sup> Chamber of Commerce of the United States, Handbook on White-Collar Crime: Everyone's Problem. Everyone's Loss 6 (1974). Obviously, these estimates can only be "ballpark" figures, for the typical perpetrator of a fraud does not file an honest "annual report." See President's Comm. on Law Enforcement & Admin. of Justice, Task Force Report: Crime and Its Impact--An Assessment 103 (1967).

<sup>67</sup> Annual Report of the U.S. Attorney General 42 (1985) (\$200 billion).

and interpersonal transactions."<sup>68</sup> Because white-collar offenders often occupy positions of trust, their misdeeds impact beyond their immediate target. Former FBI Director William H. Webster aptly commented in 1982: "[T]hrough use of their positions of trust, cunning and guile, white-collar criminals undermine professional ... integrity ... and ... are responsible for the loss of billions of dollars annually...."<sup>69</sup> Consumers, savers, investors, legitimate businesspeople and governments are the victims of such fraud.

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<sup>68</sup> See generally Herbert Edelhertz, The Nature, Impact, and Prosecution of White Collar Crime 6-7 (1970) (hereinafter "Edelhertz").

<sup>69</sup> Hearings on the Department of State, Justice and Commerce, The Judiciary and Related Agencies: Appropriations for Fiscal Year 1983, Before a Subcomm. of the Comm. on Appropriations, House of Representatives, 97th Cong., 2nd Sess. 144 (1982).

A nationwide problem of thrift and bank failures, for example, is of epidemic proportions.<sup>70</sup> The President told the Nation in 1989 that "unconscionable risk-taking, fraud and outright criminality [were] factors"<sup>71</sup> that led to this crisis, which is now expected to cost at least \$500 billion over thirty years.<sup>72</sup> Congressional studies agree with the President: At least one half of bank failures and one quarter of thrift failures involve

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<sup>70</sup> See generally Myths at 882-86; Note, Insider Abuse and Criminal Misconduct in Financial Institutions: A Crisis?, 64 Notre Dame L. Rev. 222 (1989).

<sup>71</sup> President's News Conference on Savings Crisis and Nominees, N.Y. Times, Feb. 7, 1989, at D9, col. 1.

<sup>72</sup> Michael Quint, New Estimate on Savings Bailout Says Cost Could Be \$500 Billion, N.Y. Times, Apr. 7, 1990, at A1, col. 1 (reporting General Accounting Office estimate).

criminal activity by insiders.<sup>73</sup>

Professionals played key roles in many of these failures.<sup>74</sup>

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<sup>73</sup> H.R. Rep. No. 1088, 100th Cong., 2d Sess. 2-13 (1988).

<sup>74</sup> See James S. Granelli, Keating's Advisors Under Fire: Attorneys Accountants Helped Massive Fraud Work Investors Lawyers Say, L.A. Times, Mar. 14, 1992, at D1, col. 2; Byron Harris, The S & L Looters Who May Get Away, Wall St. J. Feb. 12, 1990, A12, col. 3; Charles McCoy, Richard B. Schmit & Jeff Bailey, Hall of Shame: Besides S&L Owners, Host of Professionals Paved Way in Crisis, Wall St. J. Nov. 2, 1990, p.1, col. 6; Albert B. Crenshaw, Criminal Conduct Said to Play Role in 40% of S & L Failures, Wash. Post, July 19, 1990, at E1 (twenty percent of the failures had accountants, lawyers, brokers and other professionals at least responsible for malpractice); Leslie Wayne, Where Were The Accountants?, N.Y. Times, Mar. 12, 1989, §3 at 1, col. 2. See Lincoln Savings & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990) (Sporkin, J.) ("What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.").

Fraudulent financial reporting is a serious national problem. When fraudulent financial reporting occurs, widespread consequences result "with a sometimes devastating ripple effect."<sup>75</sup> Appropriately, since 1980, the major accounting firms at fault have had to pay millions of dollars to settle liability suits.<sup>76</sup> Little can be said for a

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<sup>75</sup> Report of the National Commission on Fraudulent Financial Reporting 4 (1987). See United States v. Benjamin, 328 F.2d 854, 863 (2d Cir.) (Friendly, J.) ("In our complex society, the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."), cert. denied, 377 U.S. 953 (1964).

<sup>76</sup> George Russell, All Eyes On Accountants: A Once Comfortable Profession Undergoes Unprecedented Scrutiny, Time, Apr. 21, 1986, at 61. See also Alison Leigh Cowan, Big Law and Auditing Firms To Pay Millions in S & L Suit, N.Y. Times, Mar. 31, 1992, at 1, col. 1 (Ernst & Young and Jones, Day, Reavis & Pogue settle Keating litigation).

construction of "conduct" within RICO that would give these white-collar offenders a safe-harbor from their just deserts.

The fraud problem facing the Nation seems overwhelming, but it is not unsolvable. If RICO--federal and state--is used with other law enforcement tools, it can emerge, as Congress and the state legislatures intended, as an effective means for combatting fraud in the thrift and banking industries,<sup>77</sup> the pension

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<sup>77</sup> Both the RTC and FDIC use RICO. See, e.g., FSLIC v. Shearson-American Express, Inc., 658 F. Supp. 1331 (D.P.R. 1987); FDIC v. Hardin, 608 F. Supp. 348 (E.D. Tenn. 1985). See generally Prosecuting Fraud in The Thrift Industry: Hearings before the House Subcomm. on Crim. Justice, 101st Cong., 1st Sess. (1989).

field<sup>78</sup> and the insurance industry.<sup>79</sup>

For "[i]f substantial progress can be made in the prevention, deterrence and

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<sup>78</sup> See, e.g., Thornton v. Evans, 692 F.2d 1064, 1065 (7th Cir. 1982) (pension plan fraud) ("Evidence...traces a pattern which seems distressingly prevalent today: the savings of working men and women are pilfered, embezzled, parlayed, mismanaged and outright stolen by unscrupulous persons occupying positions of trust and confidence."). RICO is being used successfully on behalf of plan beneficiaries. See, e.g., Crawford v. LaBoucherie Bernard Ltd., No. 83-0780 (D.D.C. Aug. 15, 1984), aff'd, 815 F.2d 117 (D.C. Cir), cert. denied, 484 U.S. 943 (1987); Note, Who Should Pay When Federally Insured Pension Funds Go Broke? A Strategy For Recovering From Wrongdoers, 65 Notre Dame L. Rev. 308 (1990).

<sup>79</sup> State insurance commissioners are using RICO to vindicate the interests of the companies that have been defrauded. See, e.g., Schacht, 711 F.2d at 1356-58; North Carolina ex. rel. Long v. Alexander & Alexander Servs., Inc., 680 F. Supp. 746, 749-51 (E.D.N.C. 1988). See generally U. S. Government Efforts to Combat Fraud and Abuse in the Insurance Industry, S. Rep. No. 102-262, 102nd Cong., 2d Sess. 17 (1992) ("unless ... forceful action is taken ... tragedies will continue....").

successful prosecution of...[white-collar] crime, we may reasonably anticipate substantial benefits to the material and qualitative aspects of our national life."<sup>80</sup>

Restricting RICO will substantially cripple the federal courts' ability to apply RICO to achieve its remedial purposes. In 1970, Congress recognized that existing jurisprudence was inadequate to deal with patterns of criminal behavior, including fraud. The Nation cannot solely rely, moreover, upon public enforcement to bear the burden of policing fraud. Over forty-five years ago Justice Jackson rightly observed that "[t]he criminal law...[has] long proved futile to reach the subtle kinds of fraud

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<sup>80</sup> Edelhertz at 11.

at all, and able to reach grosser fraud, only rarely."<sup>81</sup> Public agencies charged with policing fraud will never be funded or staffed at adequate levels.<sup>82</sup> Civil RICO's treble damage mechanism, therefore, plays an essential role.<sup>83</sup>

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<sup>81</sup> Robert H. Jackson, The Struggle for Judicial Supremacy 152 (Vintage ed. 1941).

<sup>82</sup> See, e.g., Myths at 912-16 (analysis of underfunding of SEC and CFTC). The Commodity Futures Trading Commission has been for some time "thoroughly outgunned in the ongoing battle against commodity fraud." S. Rep. No. 495, 97th Cong., 2d Sess. 10 (1983).

<sup>83</sup> See Mosler v. S/P Enters., Inc., 888 F.2d 1138, 1143-44 (7th Cir. 1989) (RICO fraud) (Easterbrook, J.): Because [such] frauds are concealable, trebling is important to produce proper incentives. (citations omitted). If perpetrators pay what they took when they get caught, and keep the proceeds the rest of the time, then fraud is profitable. If victims recoup only what they lost, and face the burdens and uncertainties of the legal process plus the costs of their

Accordingly, the statute's civil provisions are necessary if the Nation is to combat and deter fraudulent activities successfully. Private lawsuits with the threat of treble damages may, in fact, be more effective in combatting fraud than the threat of criminal penalties.<sup>84</sup>

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own counsel, then victory will not make them whole, and the shortfall may mean that victims will not vigorously investigate and litigate. Trebling [under RICO] addresses both halves of this equation.

See generally Note, Treble Damages Under RICO: Characterization and Computation, 61 Notre Dame L. Rev. 526, 533-43 (1986) ("(1) encourage private citizens to bring RICO actions, (2) deter future violators, and (3) compensate victims for all accumulative harm. These multiple and convergent purposes make the treble damage provision a powerful mechanism in the effort to vindicate the interests of those victimized by crime.").

<sup>84</sup> Empirical studies, for example, show that the threat of treble damages, not criminal prosecution, is the backbone of the antitrust statutes. "Neither imprisonment nor monetary penalties pose...a credible threat to colluding firms....[T]he deterrent

Testimony presented to Congress in 1985 by the Department of Justice indicated:

[C]ivil RICO's utility against continuous large-scale criminality not involving traditional organized crime elements should be kept in mind. These considerations suggest that private civil RICO enforcement in area[s] of organized criminality may have had a greater deterrent impact than is commonly recognized, and that both the threat and the actuality of private civil enforcement might be expected to produce even greater deterrence in the future.<sup>85</sup>

A restrictive construction of "conduct" within RICO, limiting it to manage or operate, would, therefore, deprive many

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effect...[comes] from...the likelihood of an award of private treble damages....". Michael K. Block, Roger G. Nold & Joseph G. Sidk, The Deterrent Effect of Antitrust Enforcement, 89 J. Pol. Econ. 429, 440 (1981).

<sup>85</sup> 1985 Hearings at 140-41 (testimony of Assistant Attorney General Stephen Trott).

fraud victims of access to a potent weapon in federal courts, as Congress designed it.

Nor is the potential for litigation abuse an acceptable reason for restricting the scope of civil RICO.<sup>86</sup> Allegations of civil RICO abuse should be dealt with by vigorously enforcing the existing remedies for general litigation abuse. RICO abuse will not be a problem so long as attorneys and the courts

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<sup>86</sup> Those who express this concern have the burden of proving:

- 1) that a substantial number of frivolous RICO suits are being filed.
  - 2) that existing safeguards against such suits are not adequate to remedy them.
  - 3) that new safeguards against such suits that are adequate cannot be designed, and
  - 4) that the detriment from these suits outweighs the benefit from legitimate suits.
- None of these burdens has been met. See Myths at 877-80:

"recognize the utility of existing remedial procedures."<sup>87</sup> The courts, too, should also be alert to the fact that "abuse arguments are more likely motivated by hostility to the RICO remedy."<sup>88</sup> As Justice Stevens observed in the context of the antitrust laws, "[f]rivolous cases should be treated as exactly that, and not as occasions for fundamental shifts in legal doctrine."<sup>89</sup>

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<sup>87</sup> Michael Goldsmith & Penrod W. Keith, Civil RICO Abuse: The Allegations in Context, 1986 B.Y.U. L. Rev. 55, 103 (1984). (hereinafter "RICO Abuse"). The 1983 meeting of the United States Judicial Conference concluded that "the existing tools [to address frivolous litigation] are sufficient, but perhaps not fully understood or utilized." Report of the Proceedings of the Judicial Conference of the United States, Sept. 21-22, 1983, at 56.

<sup>88</sup> RICO Abuse at 104.

<sup>89</sup> Hoover v. Ronwin, 466 U.S. 558, 601 (1984) (Stevens, J., dissenting). He continued:

Our legal system has developed

Finally, lower courts have frankly acknowledged that their restrictive reading of RICO is motivated by a fear of a "flood of litigation."<sup>90</sup> Such fears are misplaced factually<sup>91</sup> and are a constitutionally impermissible factor to employ in construing a statute. This Court teaches that the fact that litigation might be a burden on courts is "not sufficient to justify a judicial decision to alter [a] congressionally

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procedures for speedily disposing of unfound claims; if they are inadequate to protect [individuals] from vexatious litigation, then there is something wrong with those procedures, not with the law....Id.

<sup>90</sup> See, e.g., McCarthy v. Pacific Loan, Inc., 600 F. Supp. 137, 139 (D. Haw. 1984).

<sup>91</sup> Myths at 869-73 (review of civil filing data).

[drafted remedial scheme]."<sup>92</sup> It is a legislative function to resolve "the pros and cons of whether a statute should sweep broadly or narrowly."<sup>93</sup> Congress resolved those "pros and cons" when it stated unambiguously that RICO is to be construed broadly. "[R]ewriting [RICO] is [, therefore,] a job for Congress, if it is so inclined." H.J. Inc., 492 U.S. at 249 (quoting Sedima, 473 U.S. at 495). As such, the accounting profession urges a constitutionally-suspect course of action when it asks this Court to rewrite RICO on its own. This Court should have no part of it.<sup>94</sup>

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<sup>92</sup> Patsy v. Board of Regents of State of Florida, 457 U.S. 496, 512 n.13 (1982).

<sup>93</sup> United States v. Rodgers, 466 U.S. 475, 484 (1984).

<sup>94</sup> More than one hundred years ago, this Court noted that "[i]t is easy, by very ingenious and astute

### CONCLUSION

In 1970, Congress directed that RICO be liberally construed to effectuate its remedial purposes. Excluding professionals from "conduct" within RICO would be an illiberal construction of the statute. It would hobble criminal enforcement of the statute. Civil RICO's private enforcement mechanism, too, is

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construction, to evade the force of almost any statute, where a court is so disposed....[By] such a construction [it is possible to] annul [the statute] and [render] it superfluous and useless." Pillow v. Roberts, 54 U.S. (13 How.) 472, 476 (1851) (Grier, J.). Dean Roscoe Pound concluded that such "ingenious and astute" constructions (1) "tend[ed] to bring law into disrespect; (2)...subject[ed] the courts to political pressure; [and] (3)...invite[d] an arbitrary personal element in judicial administration." Roscoe Pound, III, Jurisprudence 488 (1959). It threatened, he found, to make "laws...worth little" and to "break down" the "legal order" itself. Id. at 490. See generally, Note, Civil RICO: The Temptation and Impropriety of Judicial Restriction, 95 Harv. L. Rev. 1101 (1982).

necessary if victims of fraud are to be adequately compensated. This Court should resist efforts to rewrite RICO restrictively. The Eighth Circuit's decision should, therefore, be reversed.

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No. 91-886

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IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM  
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BRIEF OF THE AMERICAN FEDERATION OF LABOR  
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AS AMICUS CURIAE IN SUPPORT OF RESPONDENT

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**BRIEF OF THE AMERICAN FEDERATION OF LABOR  
AND CONGRESS OF INDUSTRIAL ORGANIZATIONS  
AS AMICUS CURIAE IN SUPPORT OF RESPONDENT**

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This brief *amicus curiae* of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") is filed with the consent of the parties, and in support of respondent, as provided for in the Rules of this Court.

### INTEREST OF THE AMICUS CURIAE

The AFL-CIO is a federation of 89 national and international unions with a total membership of approximately 14,000,000 working men and women.

Since RICO was enacted, it has become commonplace for the participants in labor disputes to attempt to affect the balance of power through the bringing of private civil RICO suits. See Victoria G.T. Bassetti, Note, *Weeding RICO Out of Garden Variety Labor Disputes*, 92 Colum. L. Rev. 103, 122-23 & nn. 95-108 (1982) (enumerating at least thirteen means litigants have used to transform ordinary labor disputes into RICO suits).

In particular, employers increasingly are using § 1962(c) against unions engaged in strike activities, on the theory that a union conducting a strike against an employer is by that fact alone “associated” with the employer-enterprise, and that acts of picket-line wrongdoing are racketeering activity that constitutes “participation in the conduct” of the employer-enterprise’s affairs. See, e.g. *Yellow Bus Lines, Inc. v. Drivers Local 639*, 883 F.2d 132, 141-45 (D.C. Cir. 1988), *rev’d*, 913 F.2d 948 (D.C. Cir. 1990) (en banc), *cert. denied*, — U.S. —, 111 S. Ct. 2839 (1991); *Overnite Transp. Co. v. Truck Drivers Local 705*, 904 F.2d 391 (7th Cir. 1990).

That broad reading of § 1962(c) “would work a major restructuring of our legal landscape,” in that it would “giv[e] management a potentially powerful weapon to wield against striking workers.” *Yellow Bus*, 913 F.2d at 955. See also Bassetti, *Weeding RICO*, 92 Colum. L. Rev. at 126 (RICO can serve as “bludgeon” in midst of labor dispute). And so read, § 1962(c) “might apply in the context of innumerable labor-management clashes,” in a manner that would “reset the labor-management balance” carefully crafted in the elaborate set of statutes and regulations governing labor-management relations. *Yellow Bus*, 913 F.2d at 955.

It is against this background—and for this reason—that the AFL-CIO files this brief *amicus curiae* addressed to the proper reading of § 1962(c).

### SUMMARY OF ARGUMENT

We demonstrate in this brief that 18 U.S.C. § 1962(c) has a far more limited scope within the scheme of RICO—a statute that itself has a limited scope—than petitioners and the *amici curiae* on their side recognize. It is our submission that § 1962(c) addresses a particular category of corruption of enterprises *from within*: corruption through certain patterns of criminal activity committed in the conduct of an enterprise’s affairs by persons who are employed by or who are in a similar position to act on behalf of the enterprise, and who are in a position to play a part in directing the enterprise’s affairs.

In showing that this understanding of the provision is correct we analyze § 1962(c)’s place within RICO’s structure, the literal language of the provision, and its legislative background.

A. As we show in detail at pp. 7-10, *infra*, § 1962 states its substantive prohibitions in three separately enumerated subsections, each of which has a distinct role in advancing the overall objectives of the statute. Subsections (a) and (b) address two particular forms of the corruption of legitimate enterprises *from without*. Subsection (c) addresses a third—and a qualitatively different—form of the corruption of enterprises: the corruption of an enterprise *from within*. Each subsection was meant to complement, not to overlap, the others. Yet to read § 1962(c) as petitioners and the *amicus curiae* on their side do is to obliterate the differences in the roles of subsections (a), (b), and (c). Congress’ intent, as evidenced by the structure of RICO, can be realized only if the limits on the scope of each subsection stated in that subsection are respected.

B. As we show in detail at pp. 10-18, *infra*, the words of § 1962(c) set out three discernible limits that define the essence of the provision's prohibition. First, subsection (c) contains a status requirement that is not found in subsections (a) and (b): to come within § 1962(c), a defendant must, as a threshold matter, be "employed by or associated with" the enterprise. Reference to standard definitions, and application of basic canons of statutory construction, establish that these words restrict § 1962(c)'s coverage to only an enterprise's employees or those who are in a similar position to act on behalf of the enterprise.

Second, based again on the standard definitions of the words used and fundamental rules of statutory construction, the phrase "to conduct or participate, directly or indirectly, in the conduct of the enterprise's affairs" is properly understood as requiring that the defendant have a role in *directing* the enterprise's affairs. This interpretation is in accord with the result reached by the Eighth Circuit, sitting *en banc*, in *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir. 1983) (*en banc*), *cert. denied*, 464 U.S. 1008 (1983), and by the District of Columbia Circuit, sitting *en banc*, in *Yellow Bus Lines*, *supra*.

Third, subsection (c) also states that what is proscribed is the use of a pattern of racketeering activity to conduct the "enterprise's affairs." Thus, the provision does not apply to the mere use of the enterprise's resources or facilities to facilitate a defendant's conduct of his own affairs that are distinct from the enterprise's affairs.

C. As we show in detail at pp. 18-25, *infra*, the legislative history of RICO, and more particularly of § 1962, confirms the reading of § 1962(c) just outlined. Congress intended that the particular office of subsection (c) is to address the specific problem of corruption of enterprises from within, through the use of patterns of racketeering activity to conduct the affairs of enterprises.

## ARGUMENT

At its core the argument of petitioners and the *amici curiae* on petitioners' side is that 18 U.S.C. § 1962(c) is a catch all for any pattern of the wrongful conduct specified in 18 U.S.C. § 1961(1) that has any effect on an enterprise and that is committed by any third party who has any relationship with the enterprise.

The foundation for that argument, on inspection, is equal parts apocalyptic rhetoric and tendentious word-splitting. What is notably absent is any recognition that § 1962(c) is one component part of an overall statute—the Racketeer Influenced and Corrupt Organizations Act of 1970 ["RICO"]—and that RICO in turn is a component part of a compendious United States Code, and of an overall legal system that includes an even more comprehensive set of state laws.

As to the rhetoric, it is sufficient that the federal and state criminal and civil laws treat with fraudulent conduct in a myriad of ways more than adequate to assure that the Republic will survive if the words of § 1962(c) are read fairly and in context rather than as if that provision were all that stood between the American people and rampant wrongdoing that is beyond legal redress.

As to the language of § 1962(c), the method of petitioners and the *amici curiae* supporting their position is to focus selectively on particular words or phrases in the provision, and to attribute to those words or phrases in isolation the broadest allowable meaning, regardless of whether that interpretation can be reconciled with the remaining language of subsection (c) or with the overall scheme of RICO's prohibitions.

In one way or another, petitioners and the *amici curiae* supporting them would have § 1962(c) read as covering any person who commits a pattern of crimes specified

in § 1961(1) that affects, or that is otherwise related to, an enterprise.

Petitioners come to this reading of § 1962(c) without committing themselves to any particular interpretation of the provision's words. Instead petitioners simply enumerate a broad array of fact situations that subsection (c) should, in their view, be found to cover. See, e.g., Petitioners' Brief ["Pet. Br."] at 37-40 & n.15.<sup>1</sup>

The Government's brief rewrites the standard of § 1962(c) to provide for culpability whenever a defendant is shown "to have taken part in carrying out the activities of the enterprise by means of the prohibited predicate crimes." Brief for the United States as Amicus Curiae Supporting Petitioners ["Govt. Br."] at 16; see also *id.* at 21. The Government then stretches this broad standard beyond even its literal terms to cover, *inter alia*, all of the cases within the following categories: "whenever the defendant . . . uses the enterprise's resources or his association with the enterprise to facilitate his crimes; or . . . targets criminal activity so as to corrupt the enterprise's actions." *Id.* at 18.

Other of petitioners' *amici curiae* embrace the open-ended construction of § 1962(c) stated in *United States v. Scotto*, 641 F.2d 47 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981):

We think that one conducts the activities of an enterprise through a pattern of racketeering when . . . the predicate offenses are *related to* the activities of that enterprise. [641 F.2d at 54 (emphasis added).]

<sup>1</sup> Petitioners would prefer that this Court leave the proper interpretation of § 1962(c) to develop on a "case-by-case basis." Pet. Br. at 41. To that end, petitioners suggest that the jury in every RICO case simply be asked whether the defendant participated in the conduct of certain of the enterprise's affairs through the specified racketeering activity, with no further elaboration of what is meant by those terms. *Id.* at 41-43.

See, e.g., Brief of Amicus Curiae National Association of Securities and Commercial Law Attorneys (NASCAT) in Support of Petitioners at 11-13; see also Brief of Amicus Curiae National Association of Insurance Commissioners in Support of Petitioners at 15 n.15 ("outsiders to the enterprise who affect its affairs may be reached under § 1962(c)").

We demonstrate in this brief that § 1962(c) has a far more limited scope within the scheme of RICO—a statute that itself has a limited scope—than petitioners and the *amici curiae* on their side recognize.

RICO as a whole deals not with repetitive criminal activity *simpliciter* but with repetitive criminal acts that constitute the means to corrupt an organization. And § 1962(c) addresses a particular category of corruption of enterprises *from within*: corruption through certain patterns of criminal activity committed in the conduct of an enterprise's affairs by persons who are employed by or who are in a similar position to act on behalf of the enterprise and who are in a position to play a part in directing the enterprise's affairs.

In showing that this understanding is correct, we first put § 1962(c) in its place within RICO's structure; we then analyze the literal language of the provision; and finally we set out its legislative background.

#### A. The Statutory Structure

The statutory source for the reams of RICO judicial decisions and academic, professional and lay comment is disarmingly modest. Section 1961(1) sets out a list of criminal wrongs each of which constitutes "racketeering activity." Subsections 1962(a), (b) and (c) then state the three sets of circumstances in which a "pattern of racketeering activity" constitutes a violation of the statute. Subsection 1962(d), in turn, makes it unlawful to conspire to commit a violation of subsection (a), (b) or (c).

RICO's substantive provisions on their face evince a public policy of protecting ongoing organizations from three different and specific forms of corruption accomplished through a pattern of racketeering activity.

Subsections (a) and (b) quite plainly address two particular forms of the corruption of organizations *from within*—one by means of tainted funds, and the other by means of overt criminality. Specifically, subsection (a) prohibits the use of the proceeds derived from a pattern of racketeering activity to acquire an interest in, to establish, or to operate an enterprise,<sup>2</sup> while subsection (b) prohibits any person from using a pattern of racketeering activity to acquire or to maintain any interest in or control of an enterprise.<sup>3</sup>

Thus, subsections (a) and (b) proscribe a pattern of racketeering activity conducted by persons outside the enterprise that is utilized by those persons as a means to establish, gain an interest in, or take control over, an enterprise that was not an instrumentality of the racketeering activity.

<sup>2</sup> Subsection (a) provides, in pertinent part, that it

shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal . . . , to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

<sup>3</sup> Subsection (b) provides that it

shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

Subsection (c) addresses still a third—and a qualitatively different—form of the corruption of enterprises.<sup>4</sup> This subsection—on its face and, as we show below, on detailed analysis—is addressed to the corruption of an enterprise *from within*, and *not* to threats to an enterprise from the outside. In contrast to subsections (a) and (b), which deal with corrupt methods of establishing, or taking an interest in or control of an enterprise, subsection (c) deals with corrupt methods by which insiders operate an enterprise.

In drafting RICO, then, Congress has gone to the pains of stating its prohibitions in three separately enumerated subsections, each of which appears to have a distinct role, logically related to the others, in advancing an overall statutory objective. And so far as these structural clues take us, the role of each subsection is to complement, not to overlap, the others.

To read § 1962(c) as petitioners and the *amici curiae* supporting petitioners have done is to obliterate the distinct roles of subsections (a), (b), and (c). On that reading, subsection (c) certainly swallows all of subsection (b)'s prohibitions and possibly subsection (a)'s as well.<sup>5</sup>

<sup>4</sup> Subsection (c) provides that it

shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

<sup>5</sup> The predominate RICO pleading practice has been to proceed as if subsections (a), (b) and (c) were meant to overlap. Plaintiffs commonly assert multiple RICO violations—using all four subsections of § 1962(c)—arising out of a single set of facts, with numerous real and constructed enterprises alleged, so that multiple defendants can be joined and, in particular, so that defendants with substantial financial resources can be reached. “Shifting enterprise allegations for the sole purpose of targeting specific civil defendants adds to the increasingly surreal image afflicting RICO allegations.” David B. Smith & Terrance G. Reed, *Civil RICO* ¶ 7.02 at 7-22.3

That result should, at the very least, raise a caution as to the construction of the subsection proffered by petitioners and their allies. As this Court recently stated in *King v. St. Vincent's Hosp.*, — U.S. —, —, 112 S. Ct. 570, 574 (1991), “the meaning of statutory language, plain or not, depends on context,” because

“[w]ords are not pebbles in alien juxtaposition; they have only a communal existence; and not only does the meaning of each interpenetrate the other, but all in their aggregate take their purport from the setting in which they are used . . .” (quoting *NLRB v. Federbush Co.*, 121 F.2d 954, 957 (2d Cir. 1941) (L. Hand, J.)); see also *Crandon v. United States*, 494 U.S. 152, 158 (1990).]

And, as we next show, the result petitioners seek can be reached only by failing to respect the limits on the coverage of § 1962(c) stated in the language of the provision.

#### B. The Language of § 1962(c)

Subsection (c), as we have noted, forbids “any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise’s affairs through a pattern of racketeering activity . . . .”

These words set out three discernible limits that define the essence of the subsection’s particular prohibition:

(1992). See, e.g., *Petro-Tech, Inc. v. Western Co. of North America*, 824 F.2d 1349, 1358 (3d Cir. 1987) (chart enumerating plaintiff’s six alternative theories of defendant’s RICO liability, using three § 1962 subsections, several alleged enterprises, and theories of conspiracy, respondeat superior and aiding-and-abetting); *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 28-29 (1st Cir. 1987) (plaintiff alleged that three defendants, and three other entities, “individually, collectively and in any combination among them, is an ‘enterprise’”); *Hall American Center Assocs. Ltd. Partnership v. Dick*, 726 F. Supp. 1083, 1088-91 (E.D. Mich. 1989); *Grunwald v. Bornfreund*, 668 F. Supp. 128, 133-34 (E.D.N.Y. 1987) (five different enterprises alleged, including amorphous “association-in-fact”). See also Smith & Reed, *Civil RICO* ¶ 3.05 at 3-42 (describing the “protean nature of the enterprise element and the gimmickry to which RICO jurisprudence has succumbed”).

§ 1962(c) applies only to (1) an enterprise’s employees and those who have an equivalent status, who (2) have a role in directing the enterprise’s affairs, and who (3) conduct, or participate in the conduct of, the enterprise’s affairs through a pattern of racketeering activity.

1. Subsection 1962(c), first of all, contains a “status” requirement that is not found in subsections (a) and (b). To fall within § 1962(c), a defendant who has committed racketeering activity must, as a threshold matter, be “employed by,” or “associated with,” the enterprise in question.

Webster’s Third New International Dictionary identifies the relevant meaning of the verb “employ” as: “to use or engage the services of,” or “to provide with a job that pays wages or a salary or with a means of earning a living.” Webster’s Third New Int’l Dictionary 743 (1986); accord, 5 The Oxford English Dictionary 190-91 (2d ed. 1989) (defining “employed” as “in (another’s) employ,” and in turn defining the noun “employ” as “[t]he state or fact of being employed; esp. that of serving an employer for wages”). See generally *Nationwide Mut. Ins. Co. v. Darden*, — U.S. —, 112 S. Ct. 1344 (1992).

Webster’s defines the verb “associate” to mean “to join often in a loose relationship as a partner, fellow worker, colleague, friend, companion or ally[;] to come together as partners, fellow workers, colleagues, friends, companions or allies.” Webster’s Third New Int’l Dictionary at 132. Webster’s provides the following examples for the use of the adjective form: “was associated with him in a large law firm”; “were closely associated with each other during the war.” *Id.*; accord, 1 Oxford English Dictionary at 718 (identifying the principal meaning of “associated” as “[j]oined in companionship; united in action or purpose, sharing in dignity or office, allied”); Black’s Law Dictionary 156 (4th rev. ed. 1968) (“associate” “[s]ignifies confederacy or union for a particular purpose”).

Thus, on the ordinary meaning of "employed by or associated with," a defendant must be an employee of, or be otherwise allied with or a partner of, the enterprise in question in order to come within the proscriptions of § 1962(c).

Indeed, the conjunction of the phrases "employed by" and "associated with" requires that the interpretation of the latter phrase be informed by its connection in the statute to the former phrase. "The traditional canon of construction, *noscitur a sociis*, dictates that 'words grouped in a list should be given related meaning.'" *Dole v. United Steelworkers of America*, 494 U.S. 26, 36 (1990) (quoting *Massachusetts v. Morash*, 490 U.S. 107, 114-15 (1989)).<sup>6</sup> "Associated with" thus must be understood to refer to some active role in the operation of the enterprise that is distinct from yet akin to employment by the enterprise.

Equally to the point, "a court should give effect, if possible, to every clause and word of a statute." *Feist Publications, Inc. v. Rural Tel. Serv. Co., Inc.*, — U.S. —, —, 111 S. Ct. 1282, 1294 (1991) (quoting *Moskal v. United States*, 498 U.S. —, —, 111 S. Ct. 461, 466 (1990)). Accordingly, the phrase "employed by or associated with" must be read to *exclude* from the coverage of the subsection a category of persons who, in the absence of the phrase, could be said to "participate . . . in the conduct" of the enterprise's affairs, but who do *not* have the requisite relationship to the enterprise.<sup>7</sup>

<sup>6</sup> Use of this canon is particularly appropriate "where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress." *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961).

<sup>7</sup> If the racketeering activity *itself* could establish the requisite "association" with the enterprise, the "association" clause would be rendered superfluous. If § 1962(c) is construed to give effect to *all* its words, the provision "requires an association with an enterprise which is *distinct from* participation in the conduct of the enterprise through a pattern of racketeering activity." *United States v. Bledsoe*, 674 F.2d 647, 663 (8th Cir.) (emphasis added), *cert. denied*, 459 U.S. 1040 (1982). See also note 8, *infra*.

Specifically, the status requirement stated by the phrase "employed by or associated with" should, at a minimum, be understood to exclude from coverage an outsider *without* the appropriate status who might be said to participate in the conduct of enterprise's affairs by means of some kind of leverage or influence over the enterprise or its managers.<sup>8</sup> For example, the status requirement—"employed by or associated with"—should exclude from the coverage of the subsection a union representing the enterprise's employees, a business competitor of the enterprise, or the enterprise's vendors and customers, even though these entities or persons may be in a position to

<sup>8</sup> In this connection, petitioners argue that Congress' inclusion of bribery among the RICO predicate crimes somehow implies that a pattern of bribery by a person outside an enterprise must constitute a violation of § 1962(c) in the following respect: the briber is through his bribe participating in the conduct of the enterprise that employs the bribee. If the subsection were not so interpreted, according to petitioners, "RICO's coverage of bribery" would be "virtually eliminate[d]." Pet. Br. at 37; see also *id.* at 37-39; Govt. Br. at 20-21.

Putting aside other defects in this logic, the simple answer is that the conduct petitioners describe might well be subject to RICO's prohibitions in ways other than that posited by petitioners. For example, if the briber participates in the conduct of the affairs of the entity that employs him through a pattern of bribery of other entities, subsection (c) would apply to his corruption of *his own* enterprise. Cf. *Yellow Bus Lines, Inc.*, *supra*, 913 F.2d at 956 (union official may violate § 1962(c) by participating in affairs of *the union* through violence directed at employer). Or, a pattern of bribery by an outsider could violate subsection (b) if the bribes were directed at "acquir[ing] or maintain[ing] . . . any interest in or control of" the bribed enterprise. But if the statutory language is our guide the fact that a pattern of bribery is involved does not necessarily mean that a § 1962(c) violation has occurred at all, much less that a § 1962(c) violation has occurred with respect to the bribed enterprise.

Thus, petitioners' strained reading of § 1962(c) is not justified by any need to maintain the viability of "bribery" as a § 1961(l) "racketeering activity." Petitioners, for the purpose of their litigation strategy, would prefer a broader § 1962(c) than Congress wrote—one that covers bribes by outsiders to an enterprise—but that does nothing to prove that Congress wrote such a broad provision.

exercise considerable leverage or influence over how the enterprise conducts its affairs.<sup>9</sup>

2. Similarly, the natural meaning of the words, “to conduct or participate, directly or indirectly, in the conduct of [the] enterprise’s affairs”—a clause that describes a second necessary element of a violation of subsection (c)—also serves to delimit the application of the provision.

Subsection (c)’s words do not proscribe *all* participation in the enterprise’s affairs through a pattern of racketeering activity. Congress did *not* state that the provision applies to “any person employed by or associated with an enterprise” who “participates in the enterprise’s affairs through a pattern of racketeering activity.” Rather, the provision *adds* the limitation that the employee or person otherwise associated with the enterprise must engage in racketeering activity to “conduct” the affairs of the enterprise or to participate “in the conduct” of those affairs.

As is true of the word “associated,” the word “conduct”—which appears in subsection (c) as both a verb

<sup>9</sup> For cases illustrative of these and related kinds of factual configurations, but not necessarily of the analysis set forth in text, see, e.g., *Yellow Bus Lines*, *supra* (union conducted adversarial strike against enterprise employer); *Overnite Transp. Co. v. Truck Drivers Local 705*, 904 F.2d 391 (7th Cir. 1990) (same); *United States v. Mokol*, 957 F.2d 1410 (7th Cir. 1992) (deputy sheriff extorted pay-offs from enterprise company in exchange for “protection”); *United States v. Yonan*, 800 F.2d 164 (7th Cir. 1986) (lawyer bribed employee enterprise state attorney’s office to influence disposition of cases), *cert. denied*, 479 U.S. 1055 (1987); *Moffatt Enters., Inc. v. Borden, Inc.*, 763 F. Supp. 143 (W.D. Pa. 1990) (manufacturer fraudulently induced enterprise company to enter into distributorship); *Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 758 F. Supp. 64 (D.P.R. 1991) (broker fraudulently induced enterprise savings-and-loan to make inappropriate investments); *cf. Averbach v. Rival Mfg. Co.*, 809 F.2d 1016 (3d Cir.) (litigant filed false interrogatory answers with enterprise court), *cert. denied*, 482 U.S. 915, 484 U.S. 822 (1987); *Park South Assocs. v. Fischbein*, 626 F. Supp. 1108 (S.D.N.Y.) (litigants brought abusive cases in enterprise court), *aff’d*, 800 F.2d 1128 (2d Cir. 1986).

and a noun—can bear a range of meanings, depending on its context. Used as a verb, the principal meanings are “to bring by or as if by leading: lead, guide, escort”; “to lead as a commander”; and “to have the direction of: run, manage, direct.” Webster’s Third New Int’l Dictionary at 474. Similarly, as a noun the word may be used synonymously with “management” or “direction,” *id.* at 473, although, as petitioners and the Government emphasize, as a noun “conduct” also can be used in a broader sense to mean simply “the act, manner, or process of carrying forward,” *id.* See Pet. Br. at 23 n.12, Govt. Br. at 10.

Using the broader definition, and attributing that definition to the verb form of “conduct” as well as to the noun form, § 1962(c) would read: “to carry out or participate, directly or indirectly, in the carrying out of, the enterprise’s affairs.”<sup>10</sup> This is the virtual equivalent of: “to participate, directly or indirectly, in the enterprise’s affairs.” Thus, that reading, by rendering the “conduct” element meaningless, contravenes fundamental principles of statutory construction. See *supra* at 12.<sup>11</sup> As

<sup>10</sup> There is no basis in the statute for concluding that Congress in drafting § 1962(c) intended a different meaning for the verb “conduct” than for the noun “conduct.” As the Government correctly notes, it is appropriate here to give “conduct” a similar construction in both usages. Govt. Br. at 9.

A single, uniform construction of “conduct” is, indeed, supported by the short-form description of § 1962(c) that is contained in both the House and Senate Reports on RICO. Those reports say, simply, that “[s]ubsection (c) prohibits the conduct of the enterprise through the prohibited pattern or collection.” House Comm. on the Judiciary, *Report on Organized Crime Control Act of 1970*, H. Rep. No. 1549, 91st Cong., 2d Sess. 57 (1970); Senate Comm. on the Judiciary, *Report on Organized Crime Control Act of 1969*, S. Rep. No. 617, 91st Cong., 1st Sess. 159 (1969). This sentence strongly suggests that Congress meant “conduct,” used both as a verb and as a noun, to connote “direction,” or “operation.”

<sup>11</sup> The District of Columbia Circuit, *en banc*, has criticized one of the principal cases relied upon by petitioners for precisely this kind

the District of Columbia Circuit has pointed out, "Congress . . . did not proscribe mere *participation* in the enterprise's affairs through a pattern of racketeering activity, but rather, subjected participation *in the conduct* of an enterprise's affairs to RICO liability." *Yellow Bus Lines, Inc.*, *supra*, 913 F.2d at 954 (emphasis in original).

Accordingly, both uses of "conduct" in § 1962(c) should be read according to the ordinary meaning of the verb "conduct," *viz.*, "management" or "direction." This is, in essence, the construction adopted by the Court of Appeals in the instant case, Joint Appendix at 275, and, sitting *en banc*, in *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir.) (*en banc*), *cert. denied*, 464 U.S. 1008 (1983):

Mere participation in the predicate offenses listed in RICO, even in conjunction with a RICO enterprise, may be insufficient to support a RICO cause of action [under § 1962(c)]. A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself.

Or, as the *en banc* District of Columbia Circuit put it in *Yellow Bus*:

The "conduct of [the enterprise's] affairs" thus connotes more than just some relationship to the enterprise's activity; the phrase refers to the guidance, management, direction or other exercise of control over the course of the enterprise's activities. In order to participate in the conduct of an enterprise's affairs, then, a person must participate, to some extent, in "running the show." [913 F.2d at 954.]<sup>12</sup>

of selective reading of § 1962(c)'s words. In *Bank of America v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986), cited favorably in Pet. Br. at 37, the Eleventh Circuit quite literally, by use of ellipsis, "omitted the word 'conduct' in its statement of section 1962(c)'s requirements." *Yellow Bus*, 913 F.2d at 954.

<sup>12</sup> Petitioners place great weight on the phrase "participate, directly or indirectly," which petitioners remove from its context

3. Subsection (c) states as well that what is proscribed is the use of a pattern of racketeering activity to conduct the "*enterprise's* affairs."

Thus, subsection (c) cannot fairly be read to apply to the mere use of the enterprise's resources or facilities to facilitate the defendant's *own* affairs that are distinct from the enterprise's affairs. For example, if the officer of a bank were engaged in illegal drug transactions on his own account and occasionally used his phone at the bank to conduct those transactions, he would not be conducting the *bank's* affairs through this pattern of illegal drug transactions.<sup>13</sup> By contrast, if the officer were using his position within the bank to operate the bank so as to provide a facility for laundering money received in drug transactions, he would be conducting the bank's affairs through this pattern of racketeering activity.<sup>14</sup>

within the provision. Pet. Br. at 24-27, 39-40. That phrase, however, does not alter the remaining requirements of § 1962(c). Whether "direct" or "indirect," the "participation" must be participation in the *conduct* of the enterprise's affairs, rather than simply in the enterprise's affairs without more. There is no reason to attribute any more significance to the inclusion of "indirect" in the subsection than Congress' intent to cover those persons, employed by or associated with an enterprise, who, while not formally clothed with the authority to manage the enterprise, nevertheless have that authority as a practical matter by virtue of their status. Thus, for example, a major shareholder of a corporation may not be in a formal position of management or decisionmaking, but may still "indirectly" participate in the conduct of an enterprise corporation's affairs by instructing those persons who *are* in a formal position to "conduct" the enterprise's affairs in a particular way.

<sup>13</sup> Cf. *United States v. Nerone*, 563 F.2d 836, 851 (7th Cir. 1977) (no culpability under § 1962(c) where defendant's illegal gambling operation merely occurred within the geographical confines of the enterprise's property), *cert. denied*, 435 U.S. 951 (1978); *United States v. Dennis*, 458 F. Supp. 197 (E.D. Mo. 1978) (no culpability under § 1962(c) where defendant used access to the enterprise's facilities as a means for collecting his own unlawful debts).

<sup>14</sup> Cf. *United States v. Scotto*, *supra*, 641 F.2d at 51 (president of enterprise union took bribes in exchange for, *inter alia*, his

### C. The Legislative History

The legislative history of RICO, and more particularly, of § 1962, confirms the reading of § 1962(c) just outlined. Congress intended § 1962 to proscribe racketeering activity *to infiltrate, to gain control of, or to conduct* organizations. The particular office of subsection (c) is to address the specific problem of corruption of enterprises from within, through the use of patterns of racketeering activity to conduct the affairs of enterprises.

#### 1. RICO Generally

S.1861, 91st Cong., 1st Sess., the "Corrupt Organizations Act of 1969," introduced by Senators McClellan and Hruska in April 1969, is, in all relevant respects, the bill that the following year became the RICO title (title IX) of the Organized Crime Control Act of 1970. The 1969 Act "in its essentials . . . was all but identical to the final version of [RICO]." Gerard E. Lynch, *RICO: The Crime of Being a Criminal, Parts I & II*, 87 Colum. L. Rev. 661, 676-77 (1987) [hereafter "Lynch, RICO"]. In particular, § 1962 of S.1861 was in all material respects identical to the same provision that was enacted in RICO. Therefore, "[a] proper understanding of the goals of S.1861 . . . is particularly important in understanding the goals of RICO." Lynch, *RICO*, 87 Colum. L. Rev. at 677.

The goals of S.1861 are nowhere more evident than in the first line of the bill, which states that S.1861 is "A BILL [t]o amend title 18, United States Code, to prohibit the *infiltration or management* of legitimate organizations by racketeering activity or the proceeds of racketeering activity . . ." (Emphasis added.) In introducing S. 1861, Senator McClellan was clear about the problem the bill was designed to address: "The problem, simply stated, is that organized crime is increasingly *taking over* organizations in our country . . ." 115 Cong. Rec. 9567 (Sen.

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agreement to reduce number of worker's compensation claims filed through the union), *cert. denied*, 452 U.S. 961 (1981).

McClellan) (emphasis added). The bill was intended, therefore, to attack the use of racketeering activity "in the acquisition *or operation* of business." *Id.* (emphasis added). In particular, Senator McClellan stated that § 1962 of S.1861 was intended to make it unlawful "to *acquire, control or operate* organizations by the use of a pattern of racketeering activity." *Id.* (emphasis added).

This concern that organized crime was "taking over" legitimate businesses and labor unions continued to dominate Congress' consideration of RICO the following year. The concern was expressed repeatedly during the debates and in the hearings before the House and Senate.<sup>15</sup> And this emphasis was again reflected in the House and Senate Reports on the bills that became RICO.<sup>16</sup>

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<sup>15</sup> See *United States v. Turkette*, 452 U.S. 576, 591-92 & nn.13-14 (1981) (citing the legislative history); 116 Cong. Rec. at 585 (Sen. McClellan) (RICO drafted "to attack and to mitigate the effects of racketeer infiltration of legitimate organizations"); *id.* at 35196 (Rep. Celler) ("[t]itle IX is designed to inhibit the infiltration of legitimate business by organized crime"); *id.* at 35206 (Rep. Kleppe) (title IX covers "suppression of the infiltration of legitimate enterprises by racketeers or the proceeds of racketeering"); *id.* at 35295 (Rep. Poff) (title IX "provides the machinery whereby the infiltration of racketeers into legitimate businesses can be stopped and the process can be reversed when such infiltration does occur"); *id.* at 35304 (Rep. Railsback) ("This title is designed to deal with the infiltration of organized crime into legitimate business and labor."); *id.* at 35312 (Rep. Broomfield) (bill creates federal crime proscribing "the infiltration of legitimate enterprises by the rackets").

<sup>16</sup> See House Comm. on the Judiciary, *Report on Organized Crime Control Act of 1970*, H. Rep. No. 1549, 91st Cong., 2d Sess. 57 (1970) [hereafter "House Report"] ("Section 1962 establishes a threefold prohibition aimed at stopping the *infiltration* of racketeers into legitimate organizations." (Emphasis added.)); Senate Comm. on the Judiciary, *Report on Organized Crime Controls Act of 1969*, S. Rep. No. 617, 91st Cong., 1st Sess. 159 (1969) [hereinafter "Senate Report"] (same); see also *id.* at 76-78 (discussing "infiltration of legitimate businesses" and "takeover of legitimate unions").

Congress thus intended RICO to proscribe the use of racketeering (directly or by use of the proceeds derived therefrom) to become an insider in an enterprise, and the use of racketeering by those who had become insiders to run an enterprise.

## 2. Section 1962

The predecessor of S.1861—S.1623, 91st Cong., 1st Sess.—did not contain anything like what is found in § 1962(c). The prohibitions of S.1623 were directed solely at the investment of proceeds derived from criminal activity in legitimate enterprises. See 115 Cong. Rec. at 6992, 6995-96.

The Department of Justice, in remarks to the Senate, criticized S.1623 as being "deficient" in some "major respects." One of those respects was that the bill "merely prohibits the investment of prohibited funds in a business, but fails to prohibit the control or operation of such a business by means of prohibited racketeering activities." *Measures Relating to Organized Crime: Hearings Before the Subcomm. on Criminal Laws and Procedures of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess. 387 (1969) (emphasis added).

In light of this criticism, Senators McClellan and Hruska introduced S.1861, see *supra* at 18. This revised bill added what we know today as §§ 1962(b) & (c), and thus addressed the Justice Department's criticism. As Professor Lynch notes, "[w]hile still serving the goal of attacking organized crime's involvement in legitimate business, section 1962(c) takes a different approach to the problem, prohibiting not the act of infiltration itself, but the criminal activities committed by the infiltrated racketeers." Lynch, *RICO*, 87 Colum. L. Rev. at 682.

This reading is confirmed by the numerous instances in the legislative history where the legislators explained which enterprise-related acts of racketeering would be

made unlawful under § 1962 of RICO. The "threefold standard" of prohibited activities in § 1962 is described in the House and Senate Reports as follows:

(1) making unlawful the receipt or use of income from "racketeering activity" or its proceeds by a principal in commission of the activity to acquire an interest in or establish an enterprise engaged in interstate commerce [§ 1962(a)]; (2) prohibiting the acquisition of any enterprise engaged in interstate commerce through a "pattern" of "racketeering activity," [§ 1962(b)] and (3) proscribing the *operation of any enterprise engaged in interstate commerce through a "pattern" of "racketeering activity."* [House Report at 35; Senate Report at 34 (emphasis added).]

And, as the quoted passage exemplifies, whenever a member of Congress described in shorthand form the various prohibitions of § 1962, it was with reference to the "acquisition or operation of" enterprises through racketeering activity.<sup>17</sup>

<sup>17</sup> See, e.g., 116 Cong. Rec. at 602 (Sen. Hruska) ("Title IX of this act is designed to remove the influence of organized crime from legitimate business by attacking its property interests and by removing its members from control of legitimate businesses which have been *acquired or operated* by unlawful racketeering methods.") (emphasis added); id. at 607 (Sen. Byrd) ("to acquire an interest in businesses . . . , or to acquire or operate such businesses by racketeering methods"); id. at 36294 (Sen. McClellan) ("to acquire an interest in a business . . . , to use racketeering activities as a means of acquiring such a business, or to operate such a business by racketeering methods"); id. at 36296 (Sen. Dole) ("using the proceeds of racketeering activity to acquire an interest in businesses engaged in interstate commerce, or to acquire or operate such businesses by racketeering methods"); id. at 35191 (Rep. Sisk) (same exact language as in House Report, see *supra* at 21); id. at 35227 (Rep. Steiger) ("the use of specified racketeering methods to acquire or operate commercial organizations"); cf. also, e.g., id. at 592 (Sen. McClellan) (RICO would "forfeit the ill-gotten gains of criminals where they enter or operate an organization through a pattern of racketeering activity"). See also Senate Report at 81

Congress' intent, in other words, was to bring a halt to the taking over of enterprises through racketeering activity, and as a second line of defense to bring a halt to the use of racketeering activities as a means of operating such entities by those who had come to control them.<sup>18</sup>

Representative Celler, who was the Chairman of the House Judiciary Committee that voted out RICO in 1970, and one of the principal sponsors of the Organized Crime Control Act on the floor of the House, defined the prohibition stated in § 1962(c) this way: "The conduct of the affairs of a business by a person *acting in a managerial capacity*, through racketeering activity is . . . proscribed." 116 Cong. Rec. 35196 (emphasis added).

("Title IX attacks . . . the use of force, threats of force, enforcement of illegal debts, and corruption in the acquisition or operation of business.").

As these passages make clear, "acquisition" was the legislators' shorthand word for the problem dealt with by subsections (a) and (b), while "operation" of the enterprise was the shorthand for the problem dealt with in subsection (c).

<sup>18</sup> Senator Hruska explained some of the possible dangers posed when the infiltrators operate an enterprise through racketeering:

When organized crime infiltrates a legitimate business, its whole method of operation counters our theories of free competition and acts as an illegal restraint of trade. Whether a business is purchased from funds derived from its many unlawful activities, or whether it is acquired by extortion and violence, its aim is monopoly. It employs physical brutality, fear and corruption to intimidate competitors and customers to achieve increased sales and profits. The vast economic power concentrated in this giant criminal conglomerate constitutes a dire threat to the proper functioning of our economic system. [116 Cong. Rec. at 602.]

For other examples of the way § 1962(c) might address the operation of enterprises through racketeering, see *id.* at 820 (Sen. Scott) ("title IX may be a means to excise syndicate-infiltrated businesses which use force to eliminate local competition and then charge extortion prices for staple commodities and services"); *id.* at 591 (Sen. McClellan) ("Labor unions are infiltrated, and then labor peace is sold to businesses."); Senate Report at 78 (similar).

Similarly, Senator Hruska, a principal sponsor of RICO in the Senate, stated that RICO was "designed to remove the influence of organized crime from legitimate business by attacking its property interests and by removing its members *from control* of legitimate businesses which have been acquired or operated by unlawful racketeering methods." *Id.* at 602 (Sen. Hruska) (emphasis added).

In addition, the Senate Report discusses at length the danger involved in the "tak[ing] over" of businesses and of unions by racketeering elements. Senate Report at 76-78. According to the Report, the forfeiture and divestiture remedies of RICO were intended to "dislodge" racketeers from enterprises that they have "acquired or *run* by defined racketeering methods." *Id.* at 79 (emphasis added).

Having drafted the prohibitory subsections of § 1962 to accomplish these expressed objectives, Congress did not intend that the provisions be applied to racketeering activity that did not fit within the statutory bounds. While the Organized Crime Control Act of 1970 was being considered, critics of the bill raised concerns that the racketeering activities were designed so broadly that RICO would reach many crimes not necessarily typical of organized crime. See 116 Cong. Rec. 18912-14, 18939-40. Senator McClellan reassured these critics of RICO's limitations by explaining that the critical limitation is to be found not in the § 1961(1) list of predicate crimes but in the statute's other requirements, *including the specific restrictions of § 1962*:

The danger that commission of such offenses by other individuals would subject them to proceedings under title IX is even smaller than any such danger under title III of the 1968 act, since commission of a crime listed under title IX provides only one element of title IX's prohibitions. Unless an individual not only commits such a crime but engages in a pattern of

such violations, and uses that pattern to obtain or operate an interest in an interstate business, he is not made subject to proceedings under title IX. [116 Cong. Rec. 18940 (emphasis added).]<sup>19</sup>

The interpretations of § 1962(c) proffered by petitioners and by the *amici curiae* supporting petitioners would

<sup>19</sup> An uncodified section of RICO, § 904(a), see P. Law 91-452, 84 Stat. 922, 947, contains a "liberal construction" clause, which states that "[t]he provisions of this title shall be liberally construed to effectuate its remedial purposes." For the following reasons, this "liberal construction" clause cannot properly be the basis for a broader construction of § 1962(c) than the one outlined above.

First, *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479 (1985), suggests that the liberal-construction clause is confined to interpretive questions posed by § 1964, RICO's civil remedy provision:

The strict- and liberal-construction principles are not mutually exclusive; § 1961 and § 1962 can be strictly construed without adopting that approach to § 1964(c). Indeed, if Congress' liberal-construction mandate is to be applied *anywhere*, it is in § 1964, where RICO's remedial purposes are most evident. [473 U.S. at 492 n.10 (citation omitted; emphasis added).]

As the passage from *Sedima* indicates, the proper principle of statutory construction for resolving any ambiguity in the meaning of § 1962(c) is not "liberal construction," but rather, the rule of lenity. The rule of lenity applies because RICO's governing standard for civil liability is set forth in a *criminal* statute. See *Crandon v. United States*, 494 U.S. 152, 158 (1990); see also *H.J. Inc. v. Northwestern Bell Tele. Co., Inc.*, 492 U.S. 229, 255 (1989) (Scalia, J., concurring) ("RICO, since it has criminal applications as well, must, even in its civil applications, possess the degree of certainty required for criminal laws.") (citing *FCC v. American Broadcasting Co.*, 347 U.S. 284, 296 (1954)).

In any event, as we have demonstrated in the text, when examined in the context of the statute as a whole and with regard to Congress' intent, the proper construction of § 1962(c) can be discerned. Use of the liberal-construction clause to go beyond what Congress intended would be inconsistent with the appropriate judicial function. As this Court has said, that clause "'only serves as an aid for resolving an ambiguity; it is not to be used to beget one.'" *Sedima*, 473 U.S. at 492 n.10 (citation omitted).

ignore the limitations built into that provision and thus render Senator McClellan's assurances hollow.<sup>20</sup>

### CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals for the Eighth Circuit should be affirmed.

Respectfully submitted,

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<sup>20</sup> For the reasons more fully developed in the Brief for Respondent, under the proper reading of § 1962(c), the RICO claim against respondent in this case should fail. The acts in question here were performed by respondent in its capacity as an outside, independent auditor of the alleged enterprise—the farmer's cooperative. In that capacity, respondent—by definition an independent outside entity—did not meet the status requirement of § 1962(c). Moreover, the performance of an independent outside auditor does not constitute participation in the management or direction of the enterprise being audited. The audit performed and the audit reports issued by respondent were services provided to the cooperative by a service vendor, services that by their nature could only be performed by an independent, outside entity, and not by the entity being audited. Respondent's work on the audit and the oral audit reports was part of the conduct of *respondent's* affairs, not of the cooperative's affairs. If respondent performed fraudulent independent audits, or fraudulently reported on those audits, the wrongs committed were in the conduct of respondent's *own* enterprise, not that of the *cooperative's* enterprise.

(12)  
No. 91-886

Supreme Court, U.S.  
FILED

JUN 1 1992

OFFICE OF THE CLERK

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1991

BOB REVES, *et al.*,

*Petitioners,*

—v.—

ERNST & YOUNG,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

**BRIEF OF AMERICAN INSTITUTE OF  
CERTIFIED PUBLIC ACCOUNTANTS AS  
AMICUS CURIAE IN SUPPORT OF RESPONDENT**

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**QUESTION PRESENTED**

Whether the court below correctly held that the "conduct or participation" element of section 1962(c) of the RICO statute, which is embodied in the phrase "to conduct or participate, directly or indirectly, in the conduct of [the] enterprise's affairs," requires proof of some participation by the defendant in the operation or management of the RICO enterprise.

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## PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") respectfully submits this brief as *amicus curiae* pursuant to Rule 37.3 of the Rules of this Court in support of respondent Ernst & Young and urges this Court to affirm the judgment of the United States Court of Appeals for the Eighth Circuit, entered in these proceedings on June 27, 1991, and reported at 937 F.2d 1310. This brief is submitted on consent of the parties, and their written consents are being filed with the Clerk of the Court contemporaneously herewith.

## INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the national professional accounting organization, all of whose more than 300,000 members are certified public accountants. Among the Institute's purposes are the promotion and maintenance of high professional standards of practice. In the pursuit of those ends, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

As the issuer of these standards, the Institute has a profound interest in the scope and bases of civil liability in connection with auditors' performance of professional engagements sought to be imposed under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 ("RICO"), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) ("Section 10(b)" and the "1934 Act") and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"). The Institute's substantial and legitimate interest in this body of law has long been recognized both by this Court and the Congress.<sup>1</sup>

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<sup>1</sup> On the subject of RICO, the Institute participated as *amicus curiae* in *Sedima, S.P.L.R. v. Imrex Co.*, 473 U.S. 479 (1985), *H.J. Inc. v. Northwestern Bell Tel.*, 492 U.S. 229 (1989), and *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311 (1992). On the related subject of the scope of civil liability under the federal securities laws, the Institute was invited to

(footnote continued)

This case involves a claim against a member of the accounting profession and the impact of a potential reversal of the Eighth Circuit's ruling on accountants would be severe. Accountants play an integral role in the dissemination of financial information pursuant to the federal securities laws. When auditors express opinions on financial statements, they become exposed to suits brought by investors, creditors and others who may claim to have relied upon those statements in making investment decisions or entering into business transactions with auditors' clients. Upon the financial collapse of corporations, outside professionals, such as accountants, like other surviving solvent parties, are "targets of opportunity" in private RICO actions for treble damages. Dramatic expansions of civil liability under RICO, such as petitioners seek by urging this Court to reverse the decision below, foster "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739, *reh'g denied*, 423 U.S. 884 (1975).

In this case, a class of purchasers of demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (the "Co-op") alleges that Arthur Young (the predecessor of respondent Ernst & Young) committed mail fraud and securities fraud as RICO predicate acts in connection with the accounting services it provided to the Co-op. The class members, petitioners before this Court, invoked section 1962(c) of RICO, which makes it unlawful "for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enter-

(footnote continued)

and did submit a position paper to the United States Senate addressing the proposed scope of civil liabilities and damages under the 1934 Act. *Hearings on S. Res. 84 (72d Cong.), S. Res. 56, and S. Res. 97 Before the Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 15, at 7207-10 (1934)*. Furthermore, this Court has permitted the Institute to file briefs as *amicus curiae* on related securities laws issues in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979); *Aaron v. SEC*, 446 U.S. 680 (1980); *Ross v. A. H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

prise's affairs through a pattern of racketeering activity . . . ." 18 U.S.C. § 1962(c). The Eighth Circuit held that the "conduct" element of section 1962(c) requires that "[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1324 (8th Cir. 1991), *cert. granted*, 112 S. Ct. 1159 (1992), quoting from *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir.) (en banc), *cert. denied*, 464 U.S. 1008 (1983). Arthur Young's involvement in the affairs of the Co-op (the RICO enterprise in this case) was limited to conducting annual audits, meetings with the Co-op's board of directors to explain the audits, and presentations at the annual meetings regarding the audits. The Eighth Circuit concluded that "these acts in no way rise to the level of participation in the management or operation of the Co-op." *Arthur Young, supra*, 937 F.2d at 1324.<sup>2</sup>

Petitioners now urge this Court to reverse the decision below on the ground that the "operation or management" standard is an unduly restrictive interpretation of RICO that conflicts with the statute's legislative purpose. The Institute and those who use its members' professional services have an important interest in a construction of RICO that brings consistency, predictability and coherence to the express requirements for civil liability under section 1962(c) of the statute.

2 In its *amicus* brief, the United States concedes that auditors are required to maintain independence, or "an arm's-length professional relationship with a client," and "[t]hat relationship, standing alone, does not implicate RICO." Brief for United States at 22, citing and quoting from *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) ("'public watchdog' function [of accountants] demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust"). The Institute's Code of Professional Conduct also requires certified public accountants to "maintain objectivity" and "be independent in fact and appearance when providing auditing and other attestation services." Professional Standards, *Principles of Professional Conduct*, art. IV (AICPA 1991). A similar independence requirement for public accountants is imposed by SEC Regulation S-X, Rule 2-01(b), 17 C.F.R. § 210.2-01(b).

Because the decision below offers such a construction, the Institute urges its affirmance.

### STATEMENT OF THE CASE

The petitioners in this case are Bob Reves, Robert H. Gibbs and Frances Graham, as representatives of a class of persons who purchased demand notes from the Co-op between February 15, 1980 and February 23, 1984. The Co-op was organized in 1946 and it sold demand notes to raise money for its operating expenses until it filed for bankruptcy on February 23, 1984.

Arthur Young was first retained to provide accounting services to the Co-op as its independent auditor in 1981. In that capacity, Arthur Young issued audit reports on the Co-op's financial statements for the years ending December 31, 1981 and December 31, 1982. Arthur Young's representatives also gave brief oral presentations on the financial condition of the Co-op at its annual meetings in May 1982 and March 1983.

The Co-op operated as a debtor-in-possession from the time of its bankruptcy filing until October 1984, when the bankruptcy court appointed a trustee. On February 14, 1985, the bankruptcy trustee filed an action in the United States District Court for the Western District of Arkansas on behalf of the Co-op and certain demand noteholders against 40 individuals and entities including the Co-op's general manager, members of the Co-op's board of directors, several of the Co-op's lawyers, Arthur Young, and two auditors that preceded Arthur Young.

The complaint asserted various state and federal claims against the defendants, including common law fraud, violations of the registration and disclosure provisions of the Arkansas Securities Act, and violations of Section 10(b), Rule 10b-5 and RICO. The gravamen of the complaint against Arthur Young was that it had misvalued the Co-op's assets and thereby allowed the Co-op's financial statements to be misstated. With respect to RICO, the complaint alleged that Arthur Young conducted or participated in the conduct of

the affairs of the Co-op through a pattern of racketeering activity consisting of mail fraud and securities fraud in violation of 18 U.S.C. § 1962(c).

After the close of extensive discovery, Arthur Young moved for summary judgment on the RICO claim and urged two grounds for dismissal: first, petitioners could not demonstrate that it had conducted or participated in the conduct of the Co-op's affairs within the meaning of section 1962(c) of RICO; and, second, that petitioners could not demonstrate that it had participated in a pattern of racketeering activity within the meaning of that statute. The district court granted Arthur Young's motion on the first ground and held that, under the Eighth Circuit's decision in *Bennett v. Berg, supra*, 710 F.2d at 1364, mere participation in auditing activities could not constitute participation in the conduct of the affairs of a RICO enterprise under section 1962(c).

Following a trial on the complaint's remaining claims, the jury found that Arthur Young had committed primary violations of section 10(b) of the 1934 Act and Rule 10b-5 and secondary violations of the Arkansas securities statute. The jury awarded actual damages of \$6.1 million to members of the class who purchased demand notes between the time that Arthur Young submitted its first audit report to the Co-op's board and the date on which the Co-op filed for bankruptcy.

Arthur Young and petitioners each appealed from the district court's judgment to the United States Court of Appeals for the Eighth Circuit. Initially, the Eighth Circuit held that the demand notes were not securities under federal and state law and reversed the district court judgment. See *Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988). This Court reversed that decision and held that the demand notes were securities under the federal securities laws. See *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990).

On remand, the Eighth Circuit affirmed the district court judgment against Arthur Young under Section 10(b) of the 1934 Act, Rule 10b-5 and the Arkansas securities statute. The Eighth Circuit also affirmed the district court's grant of summary judgment for Arthur Young on the RICO claim. See 937 F.2d at 1324.

## SUMMARY OF ARGUMENT

Section 1962(c) of RICO makes it unlawful "for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity . . . ." 18 U.S.C. § 1962(c). While the term "conduct" as used in section 1962(c) is undefined, the ordinary meaning of this word, RICO's legislative history and its structure all support the Eighth Circuit's conclusion that participation in the "operation or management" of a RICO enterprise's affairs must be proven in order to satisfy the "conduct" element of the statute. Most courts that have analyzed section 1962(c)'s "conduct" element separately have concluded that it should be interpreted to require proof of something more than a defendant's commission of offenses comprising the pattern of racketeering activity, even when the requisite pattern has a nexus to the statutory enterprise. The Eighth Circuit interpreted the "conduct" element to require proof of some participation in the "operation or management" of the affairs of the enterprise itself. This interpretation is not only faithful to the meaning and intent of the statute, but it also furthers important public policy considerations.

The question presented here is essentially one of statutory construction of certain of RICO's undefined language. The Eighth Circuit's interpretation of section 1962(c)'s "conduct" language to require that defendants participate in the "operation or management" of an enterprise's affairs is consonant with the ordinary meaning of the word "conduct," used in the key statutory passage both as a noun and as a verb. As a verb, it is synonymous with the word "manage;" as a noun it is synonymous with "management."

The legislative history of RICO also supports the "operation or management" standard. Contemporaneous statements by the sponsors of bills that ultimately were enacted as RICO demonstrate that section 1962(c) was intended to prohibit the operation and management of legitimate organizations by racketeers and organized crime. Moreover, the reports issued

by the Senate and House judiciary committees are replete with statements evidencing this legislative intent. In reports and statements by RICO's sponsors, there are repeated references to the "operation" of an enterprise by racketeers or organized crime as an activity that section 1962(c) was designed to eliminate. In sum, the legislative history of section 1962(c) establishes that the "conduct or participate" language in the statute requires some involvement by defendants in the operation or management of enterprises.

Significantly, the "operation or management" standard has been adopted by most of the Courts of Appeals that have considered the separate "conduct" element of section 1962(c). As this Court has recognized, the "conduct" element of section 1962(c) is separate from that section's "through" element. The Courts of Appeals for the Fourth, Eighth, Ninth and District of Columbia Circuits have analyzed section 1962(c)'s "conduct" element separately and each has adopted in slightly varying form the "operation or management" standard. Only the Courts of Appeals for the Fifth and Eleventh Circuits have concluded that it is not necessary for a RICO defendant to participate in the operation or management of an enterprise under section 1962(c). By requiring that defendants have a significant degree of involvement in the conduct of an enterprise's affairs, the majority of decisions in the Circuits thus ensure that RICO liability is kept within legislatively defined bounds, and this view should be affirmed here.

A contrary result would effectively extend the reach of RICO to defendants who had little, if any, involvement in the conduct of an enterprise's affairs. Such a result will contribute to the continuing, undisciplined growth of RICO actions against accountants and other professionals. The exposure to risk of treble damages, potentially irreparable harm to professional reputation, and time-consuming and expensive litigation are factors that promote extortive settlements. The unwarranted expansion of accountants' liability may impede or prevent the critical flow of financial information because accounting services will become more expensive or unavailable, which ultimately will harm investors, the capi-

tal markets, and competition. All these adverse policy results are avoided by adoption of the "operation or management" standard which provides a principled basis on which to tailor liability to statutorily prohibited acts.

## ARGUMENT

### POINT I

#### THE DECISION BELOW INTERPRETED THE CONDUCT ELEMENT OF SECTION 1962(c) IN ACCORDANCE WITH THE PLAIN LANGUAGE, LEGISLATIVE HISTORY AND STRUCTURE OF RICO.

As this Court has recognized, "the major purpose" of RICO is "to address the infiltration of legitimate business by organized crime." *United States v. Turkette*, 452 U.S. 576, 591 (1981). In support of this salutary purpose, Congress has declared that "[t]he provisions of [RICO] shall be liberally construed to effectuate its remedial purposes," Organized Crime Control Act of 1970, Pub. L. No. 91-452, § 904(a), 84 Stat. 922, 947, and this Court has held that "RICO is to be read broadly," *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 497 (1985).

As RICO's treble damages and attorney's fee provision have made RICO the statutory action of choice among civil litigants, see 18 U.S.C. § 1964(c), this Court has observed that, "[i]nstead of being used against mobsters and organized criminals, it has become a tool for everyday fraud cases brought against 'respected and legitimate "enterprises." ' " *Sedima, supra*, 473 U.S. at 499, quoting from *Sedima, S.P.R.L. v. Imrex Co.*, 741 F.2d 482, 487 (2d Cir. 1984). In response to "this increasing divergence," and the "'extraordinary, if not outrageous,' uses to which civil RICO has been put," this Court also has expressed concern that, "in its private civil version, RICO is evolving into something quite different from the original conception of its enactors." *Sedima, supra*, 473 U.S. at 499, 500.

This Court's well-founded expressions of concern regarding the use of RICO in garden-variety fraud cases and ordinary commercial disputes involving respected business persons and firms make it essential that section 1962(c)—RICO's most commonly invoked proscriptive provision—be interpreted and applied in accordance with its plain language, legislative history and structure. An analysis of RICO's plain language, legislative history and structure demonstrates that the court below was correct in holding that section 1962(c)'s "conduct or participate" element requires proof of "some participation" by defendants "in the operation or management of the enterprise itself." *Arthur Young, supra*, 937 F.2d at 1324.

#### A. The "Operation Or Management" Standard Is Supported By The Ordinary Meaning Of The Words Used In Section 1962(c).

This Court has instructed that, "[i]n determining the scope of a statute, we look first to its language. If the statutory language is unambiguous, in the absence of 'a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive.' " *Russello v. United States*, 464 U.S. 16, 20 (1983), citing *United States v. Turkette*, 452 U.S. 576, 580 (1981), quoting from *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980).

The unambiguous language of section 1962(c) makes it unlawful "for any person employed by or associated with any enterprise . . . to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity . . . ." 18 U.S.C. § 1962(c). In *Sedima*, this Court held that a violation of section 1962(c) requires "(1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity." *Sedima, supra*, 473 U.S. at 496. Only the "conduct" element of section 1962(c) is directly at issue in this case. See *Arthur Young, supra*, 937 F.2d at 1324.

The "conduct" and "participate . . . in the conduct of" language of section 1962(c) "is not specifically defined in the

RICO statute.” *Russello, supra*, 464 U.S. at 21. “This silence compels [this Court] to ‘start with the assumption that the legislative purpose is expressed by the ordinary meaning of the words used.’ ” *Id.*, quoting from *Richards v. United States*, 369 U.S. 1, 9 (1962). To determine the ordinary meaning of undefined statutory terms, this Court frequently considers their dictionary definitions. *See, e.g., H.J. Inc. v. Northwestern Bell Tel.*, 492 U.S. 229, 238 (1989); *Russello, supra*, 464 U.S. at 21.

Section 1962(c) uses the term “conduct” as a verb *and* as a noun. When section 1962(c) uses “conduct” as a verb, as in the phrase “to conduct . . . such enterprise’s affairs,” “conduct” means “manage” according to Black’s Law Dictionary 367 (5th ed. 1979). Webster’s Ninth New Collegiate Dictionary 274 (1987)—which identifies “manage” as a synonym of the verb “conduct”—defines “conduct” in language virtually identical to the language used in the decision below: “to direct or take part in the operation or management of . . . a business [emphasis added.]” Random House Dictionary of the English Language 426 (2d ed. 1987) also defines the verb “conduct” to mean “manage” and offers these illustrations: “to conduct a meeting; to conduct a test.” *See also* Webster’s Third New International Dictionary 474 (1976) (verb “conduct” defined as “manage;” “manage” identified as a synonym of the verb).<sup>3</sup>

When section 1962(c) employs the term “conduct” as a noun, in the phrase “participate . . . in the conduct of such enterprise’s affairs,” the noun “conduct” means “management,” as in “the conduct [or management] of a business.” Random House Dictionary of the English Language 426 (2d ed. 1987). Webster’s Ninth New Collegiate Dictionary 274 (1987) similarly defines “conduct” to mean: “the act, manner, or process of carrying on: MANAGEMENT.”<sup>4</sup> As

3 In the *amicus* brief submitted by Trial Lawyers for Public Justice (“TLPJ”) in support of petitioners, TLPJ admits that “‘conduct’ as a verb (‘to conduct’) may mean management, direction, etc.” Brief for TLPJ at 24.

4 Petitioners quote part of this definition in their brief; however, they omit the word “MANAGEMENT.” Brief for Petitioners at 23 n.12. The

(footnote continued)

defined there, “MANAGEMENT” is offered as synonymous with the noun “conduct,” and thus “may stand alone as the only definitional matter” for the noun. *Id.* at 21. Finally, Webster’s Third New International Dictionary 473 (1976) defines the noun “conduct” to mean: “the act, manner, or process of carrying out (as a task) or carrying forward (as a business . . . ); MANAGEMENT[.]” *Accord Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union* 639, 913 F.2d 948, 954 (D.C. Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 2839 (1991) (“‘Conduct’ is synonymous with ‘management’ or ‘direction’ ”).<sup>5</sup>

In short, the “ordinary meaning,” *Russello, supra*, 464 U.S. at 21, of the verb “conduct” demonstrates that section 1962(c)’s use of that term is synonymous with the verb “manage” (as in “to [manage] . . . [an] enterprise’s affairs through a pattern of racketeering activity”). Dictionary definitions of the noun “conduct” similarly demonstrate that section 1962(c)’s use of that term is synonymous with the noun “management” (as in “participate . . . in the [management] of such enterprise’s affairs through a pattern of racketeering activity”).

(footnote continued)

prepositional phrase “in the conduct of” is the nounal form of the verb “to conduct,” and has—as the dictionary definitions in text make clear—a denotation distinct from the noun “conduct” used in a different construction to mean “behavior” generally. *Compare* definitions 2 and 3 in Webster’s, *op. cit.* By truncating their references to the definition, petitioners lose this nuance, which is critical to the usage employed by Congress.

5 In a flawed attempt to support petitioners, TLPJ (note 3, *supra*) argues that, if the noun “conduct” is read to mean “‘management,’ it becomes superfluous” because “[t]he sentence would read ‘to manage . . . in the management of.’ ” Brief for TLPJ at 24-25. This argument contradicts common sense and it is based on a tortured construction of section 1962(c). For example, it is not superfluous “to manage *or* participate, directly or indirectly, in the management of such enterprise’s affairs[.]” *See* 18 U.S.C. § 1962(c) (emphasis added).

**B. The "Operation Or Management" Standard Is Supported By An Analysis Of Section 1962(c)'s Legislative History.**

As this Court has observed, "there is no errorless test for identifying or recognizing 'plain' or 'unambiguous' language." *Turkette*, 452 U.S. at 580. Thus, "[f]or any more specific guidance as to the meaning of" statutory terms not defined in the statute, *H.J.*, *supra*, 492 U.S. at 238-39, this Court "must look past the text to RICO's legislative history," *id.* at 239, just as it "ha[s] done in prior cases construing the Act." *H.J.*, *supra*, citing, *inter alia*, *Sedima*, *supra*, 473 U.S. at 486-90; *Russello*, *supra*, 464 U.S. at 26-29; *Turkette*, *supra*, 452 U.S. at 589-93. Section 1962(c)'s legislative history demonstrates that RICO's primary sponsors intended section 1962(c)'s term "conduct" to require some involvement by the RICO defendant in the "operation or management" of the enterprise's affairs.

On January 15, 1969, Senator McClellan, chairman of the Senate Judiciary Committee, introduced S.30, known as the Organized Crime Control Act of 1969; the bill addressed various areas of criminal law, including grand juries, immunity and sentencing, but it "contained no provision like that now known as RICO." *Sedima*, *supra*, 473 U.S. at 515 (Marshall, J., dissenting); see 115 Cong. Rec. 769 (1969); H. Rep. No. 91-1549, 91st Cong., 2d Sess. (1970) reprinted in 1970 U.S. Cong. Code & Ad. News 4007, 4012 (hereinafter the "House Report" or "H. Rep. No. 91-1549"). Shortly thereafter, Senator Hruska introduced S.1623, the Criminal Activities Profits Act. See *Sedima*, *supra*; 115 Cong. Rec. 6995-96 (1969); Lynch, *RICO: The Crime of Being a Criminal, Parts I & II*, 87 COLUM. L. REV. 661, 676 (1987) (hereinafter "Lynch, *RICO: The Crime*"). Senator Hruska explained that S.1623 was intended to attack "the economic power of organized crime and its exercise of unfair competition with honest businessmen" and that it was "aimed specifically at racketeer infiltration of legitimate business." 115 Cong. Rec. 6993 (1969).

In his introductory remarks regarding S.1623, Senator Hruska referred specifically to the ownership and operation

of legitimate businesses by racketeers and organized crime as activities that the bill was intended to eliminate:

It is tragic for the public to permit racketeers to *own and operate* ostensibly legitimate businesses.

115 Cong. Rec. at 6993 (emphasis added). In order to attack the ownership and operation of legitimate enterprises by racketeers and organized crime, section 2(c) of S.1623 made it a felony for any person to use "intentionally unreported income derived by such person from a proprietary interest in any business enterprise" to "*establish or operate* any such other business enterprise . . . ." 115 Cong. Rec. at 6995-96 (emphasis added); see Lynch, *RICO: The Crime*, *supra*, at 676.

The Senate "did not act directly on either S.30 or S.1623." *Sedima*, *supra*, 473 U.S. at 516 (Marshall, J., dissenting). "Instead, Senators McClellan and Hruska jointly introduced S.1861, the Corrupt Organizations Act of 1969, 91st Cong., 1st Sess.; 115 Cong. Rec. 9568-9571, which combined features of the two other bills and added to them." *Id.*; see also Lynch, *RICO: The Crime*, *supra*, at 676-77. Significantly, Senator McClellan described S.1861 as an amendment to Title 18 of the United States Code designed to "prohibit the infiltration *or management of legitimate organizations* by racketeering activity or the proceeds of racketeering activity." 115 Cong. Rec. 9568 (emphasis added).

As introduced, section 1962 of S.1861, the "core of the statute,"<sup>6</sup> had three subsections that in substantial part later were enacted as sections 1962(a), (b) and (c). See 115 Cong. Rec. at 9569; compare 18 U.S.C. §§ 1962(a)-(c).<sup>7</sup> Senator McClellan's introductory remarks for S.1861 noted that:

<sup>6</sup> Lynch, *RICO: The Crime*, *supra*, at 680.

<sup>7</sup> Section 1962(c) of S.1861 provided:

It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in

(footnote continued)

Section 1962 sets forth the forbidden activities, which are to acquire, control or *operate* organizations by the use of a pattern of racketeering activity as defined in section 1961[.]

115 Cong. Rec. at 9567 (emphasis added). Senator McClellan also explained that, because S.1861 was primarily remedial, the focus of the bill was on eliminating the influence of persons who acquired or operated legitimate organizations through a pattern of racketeering activity:

If an organization is acquired *or run* by the proscribed racketeering method, then the persons involved are [to be] removed from the organization.

*Id.* (emphasis added).

In light of Senator McClellan's unambiguous remarks regarding the use of section 1962 to eliminate racketeers and organized crime from the "management" and "operat[ion]" of legitimate organizations, and the use in section 1962(c) of S.1861 of "conduct" and "participate" language identical to that used in section 1962(c) as enacted, the bill's sponsor apparently viewed "management," "operate" and "conduct" as terms of ordinary meaning that could be used interchangeably in section 1962(c).<sup>8</sup>

At the request of Senator McClellan, the provisions of S.1861 were incorporated by amendment into S.30. *Sedima*,

(footnote continued)

the conduct of such enterprise's affairs through a pattern of racketeering activity.

115 Cong. Rec. 9569 (1969). The only change between section 1962(c) as introduced as part of S.1861 and as enacted as part of Title 18 of the United States Code is that the phrase "or collection of an unlawful debt" was inserted after the terms "pattern of racketeering activity." As enacted, section 1962(d) prohibited conspiracies to violate the other three substantive provisions of section 1962.

<sup>8</sup> Senator McClellan's remarks are entitled to special deference because "[i]t is the sponsors that we look to when the meaning of the statutory words is in doubt." *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 394-95 (1951) (Douglas, J.).

*supra*, 473 U.S. at 516 (Marshall, J., dissenting); 115 Cong. Rec. 9566-71 (1969). On December 16, 1969, the Senate Judiciary Committee reported favorably on S.30, as amended to include S.1861. See S. Rep. No. 91-617, 91st Cong., 1st Sess. (1969) (hereinafter the "Senate Report" or "S. Rep. No. 91-617").

The Senate Report explains that Title IX of S.30 "creates a new chapter in title 18, entitled 'Racketeer Influenced and Corrupt Organizations,' which contains a threefold standard" in section 1962 designed to eliminate the infiltration of legitimate organizations. S. Rep. No. 91-617, *supra*, at 34; see Lynch, *RICO: The Crime*, *supra*, at 678 n.83.<sup>9</sup> According to the Senate Report, the third prong of this standard (which correlates to section 1962(c) as enacted):

proscrib[es] the *operation* of any enterprise engaged in interstate commerce through a "pattern" of "racketeering activity[.]"

*Id.* (emphasis added).

According to the Senate Report, Title IX authorized district courts to use "civil process" to "prevent and restrain . . . violations of the above standard by, among other things, the issuance of (1) orders of divestment, (2) prohibitions of business activity, and (3) orders of dissolution or reorganization." S. Rep. No. 91-617, *supra*, at 34. The Senate Report explained that these "new remedies" were

<sup>9</sup> In response to a request by the Senate Judiciary Committee "for the Department of Justice's views on S.1861[.]" the Department of Justice responded in a letter dated August 11, 1969, which stated in pertinent part:

The prohibitions contained in section 1962 of the bill appear to be broad enough to cover most of the methods by which *ownership, control, and operation of business* are achieved.

S. Rep. No. 91-617, *supra*, at 123 (emphasis added). When read in its entirety, this letter reflects an understanding on the part of the Department of Justice that Congress sought to address the operation of businesses by racketeers and organized crime through section 1962(c) of S.1861. The fact that the Senate Judiciary Committee included the letter in its Report without reservation or qualification suggests strongly that Congress agreed with the letter's content. See, e.g., *Palmer v. Hoffman*, 318 U.S. 109, 112 n.3 (1943).

designed to eliminate racketeers and organized crime from the "acquisition" and "operation" of legitimate businesses:

Title IX recognizes that present efforts to dislodge the forces of organized crime from legitimate fields of endeavor have proven unsuccessful. To remedy this failure, the proposed statute adopts the most direct route open to accomplish the desired objective. Where an organization is acquired *or run* by defined racketeering methods, then the persons involved can be legally separated from the organization, either by the criminal law approach of fine, imprisonment and forfeiture, or through a civil law approach of equitable relief broad enough to do all that is necessary to free the channels of commerce from all illicit activity.

*Id.*, at 79 (emphasis added). The Senate Report concluded that removing "criminal elements from the organizations of our society by divestiture is justified" because Title IX attacks "the use of force, threats of force, enforcement of illegal debts, and corruption in the acquisition *or operation of business.*" *Id.*, at 81 (emphasis added).<sup>10</sup>

On January 23, 1970, the Senate passed S.30, after which the bill was considered by the House. *Sedima, supra*, 473 U.S. at 518 (Marshall, J., dissenting); H. Rep. No. 91-1549, *supra*, at 4012. In the House, Representative Celler explained that Title IX was "designed to inhibit the infiltration of legitimate business by organized crime" and that, under section 1962(c), "[t]he conduct of the affairs of a business *by a person acting in a managerial capacity*, through racketeering activity[,] is also proscribed." 116 Cong. Rec. 35196 (1970) (emphasis added). Representative Railsback similarly explained that section 1962 "makes it a crime to use organized crime profits or methods to establish, acquire, *or oper-*

<sup>10</sup> The Senate Report also notes that, by "effectively remov[ing] the criminal figure from the particular corrupt organization[,] the "prohibition is not a penalty against any individual[,] but "instead a protection of the public against parties engaging in certain types of businesses after they have shown that they *are likely to run the organization* in a manner detrimental to the public interest." S. Rep. No. 91-617, *supra*, at 82 (emphasis added).

*ate any legitimate business.*" 116 Cong. Rec. 35304 (1970) (emphasis added).

In September 1970, the House Judiciary Committee reported favorably on S.30, with amendments, *see* H. Rep. No. 91-1549, *supra*, at 4012, after which the Senate passed the bill without a conference as the Organized Crime Control Act of 1970. *Sedima, supra*, 473 U.S. at 519 (Marshall, J., dissenting); Pub. L. No. 91-452, 84 Stat. 922, 941 (1970).

The foregoing review of the legislative history of section 1962(c)—particularly the repeated use of the word "operation" to describe the substantive scope and purpose of section 1962(c)—demonstrates that the statutory term "conduct" requires some involvement by defendants in the operation or management of enterprises. This requirement appears to reflect both a legislative determination to focus the statute's prohibitions on the conduct Congress had found offensive to the public interest and a decision that exposure to the severe sanctions available under RICO should be kept within expressly defined bounds by triggering them only upon a showing that defendants have a significant degree of involvement in the affairs of a RICO enterprise.

### C. The "Operation Or Management" Standard Has Been Adopted By Most Courts That Have Considered The Separate "Conduct" Element Of Section 1962(c).

Section 1962(c)'s requirement that a defendant "conduct or participate . . . in the conduct of [an] enterprise's affairs" is an element separate from the requirement that an enterprise's affairs be conducted "through a pattern" of racketeering activity. *See Sedima, supra*, 473 U.S. at 496.<sup>11</sup> Most Courts of Appeals which have construed the "conduct" element, as distinct from the "through" element, have concluded that the

<sup>11</sup> *Accord Occupational-Urgent Care Health Systems, Inc. v. Sutro & Co.*, 711 F. Supp. 1016, 1026-27 (E.D. Cal. 1989) (complaint's allegations held inadequate to satisfy either "conduct" element or "through" element); *Lipin Enterprises v. Lee*, 625 F. Supp. 1098, 1100 (N.D. Ill. 1985) (same), *aff'd*, 803 F.2d 322 (7th Cir. 1986). The United States in its *amicus* brief to this Court concedes that section 1962(c)'s "conduct" element is separate from the statute's "through" element. *See* Brief for United States at 8.

"conduct" element requires proof of participation in the "operation or management" of the enterprise. See *United States v. Mandel*, 591 F.2d 1347, 1375 (4th Cir. 1979), *cert. denied*, 445 U.S. 961 (1980); *United States v. Zemek*, 634 F.2d 1159, 1172 (9th Cir. 1980), *cert. denied*, 450 U.S. 916 (1981); *Bennett v. Berg*, 710 F.2d 1361, 1364 (8th Cir.) (en banc), *cert. denied*, 464 U.S. 1008 (1983); *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 952-54 (D.C. Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 2839 (1991); but see *Bank of America v. Touche Ross & Co.*, 782 F.2d 966, 970 (11th Cir. 1986) (expressly rejecting the *Bennett* "operation or management" standard after analyzing section 1962(c)'s "conduct" element separately); cf. *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 533-34 n.8 (5th Cir. 1992).<sup>12</sup>

In *Mandel*, a panel of the United States Court of Appeals for the Fourth Circuit decided that a transfer of a partnership interest in a RICO enterprise from one defendant to another was insufficient to satisfy the "conduct or participate" element of section 1962(c). In doing so, the court extensively reviewed the legislative history of section 1962(c), "particularly the repeated use of the word 'operation' in describing the purpose of § 1962(c)," and concluded that the "'conduct or participate' language in § 1962(c) require[s] some involvement in the operation or management of the business." 591 F.2d at 1375.<sup>13</sup> The Fourth Circuit's decision in *Mandel* has been followed in three other circuits. In *Zemek*, the United States Court of Appeals for the Ninth Circuit adopted *Mandel*'s "operation or management" standard in reviewing the sufficiency of the evidence in a RICO

<sup>12</sup> Petitioners therefore err in their contention that the Eighth Circuit's "operation or management" standard has been rejected by "other circuits (six of which have conflicting tests)." Brief for Petitioners at 31.

<sup>13</sup> The *Mandel* court also concluded that the "through" element had not been satisfied because "the simple transfer of an ownership interest" in a "perfectly legitimate business" does not "constitute the conduct of the business through a pattern of racketeering activity even if the transfer is part of an alleged payoff in a mail fraud scheme." *Id.* at 1376.

criminal case, and concluded there was "ample evidence of Zemek's participation and involvement in the operation" of an illegal association-in-fact enterprise (defined as the business of operating taverns in Pierce County, Washington) in the proof that Zemek solicited someone to burn a rival tavern and made admissions regarding his involvement in other acts of arson. 634 F.2d at 1171-72.<sup>14</sup> In a decision which the court below expressly followed, the United States Court of Appeals for the Eighth Circuit, sitting *en banc*, held in *Bennett v. Berg* (following *Mandel*), that "[a] defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." 710 F.2d at 1364.<sup>15</sup> In *Yellow Bus*, the United States Court of Appeals for the District of Columbia Circuit, sitting *en banc*, adopted in substantially identical form the standard announced in *Bennett*, and held that section 1962(c) is satisfied "when a defendant, through a pattern of racketeering activity, exercises significant control over or within an enterprise, participating not merely in the enterprise's affairs, but in the

<sup>14</sup> Petitioners and certain *amici* that support them err in their suggestion that the Ninth Circuit, in *United States v. Yarbrough*, 852 F.2d 1522, 1544 (9th Cir.), *cert. denied*, 488 U.S. 866 (1988), adopted a different construction of section 1962(c)'s "conduct" element. See Brief for Petitioners at 40 n.16; Brief for United States at 9 n.7; Brief for NASCAT at 11-14. In *Yarbrough*, the Ninth Circuit construed only the "through" element of section 1962(c). The "conduct or participate" element was not even addressed because the defendant admitted his membership in the radical right-wing, white-supremacist group known as the "Order"—an illegal association-in-fact enterprise—and also admitted that he had "engaged in a 'pattern of racketeering activity[.]'" 852 F.2d at 1526, 1544.

<sup>15</sup> In its decision below, the panel, noting that it was "bound" to follow *Bennett*, applied the *Bennett* standard and concluded that the acts of Arthur Young "in no way rise to the level of participation in the management or operation of the Co-op." See *Arthur Young*, *supra*, 937 F.2d at 1324. Petitioner's assertion that the adoption of the "operation or management" standard in *Bennett* was dictum which the court below was free to ignore is wrong. See Brief for Petitioners at 31.

conduct of the enterprise's affairs." 913 F.2d at 954 (emphasis in original).<sup>16</sup>

The Institute respectfully submits that the Eleventh Circuit erred in its conclusion in *Bank of America* that "[i]t is not necessary that a RICO defendant participate in the management or operation of the enterprise." 782 F.2d at 970. The Eleventh Circuit rejected the "operation or management" standard based on a misunderstanding that "[t]he word 'conduct' in § 1962(c) simply means the performance of activities necessary or helpful to the operation of the enterprise." *Bank of America, supra*, 782 F.2d at 970 (citing *United States v. Martino*, 648 F.2d 367, 382 (5th Cir. 1981), *aff'd on other grounds sub nom., Russello v. United States*, 464 U.S. 16 (1983)). Such a construction effectively renders the "conduct" element meaningless, since it is hard to conceive of a case in which a "pattern of racketeering activity" could be shown in which "activities necessary or helpful to the operation of the enterprise" would not necessarily be shown by the same proof. The fallacy of the Eleventh Circuit's interpretation, which leaves the "conduct" language of RICO as surplusage, is demonstrated by the fact that it relied on a case interpreting "conduct" in a very different context where the

<sup>16</sup> Petitioners contend that the decision below, by relying upon *Yellow Bus*, modified the *Bennett* "operation or management" standard so as to require defendants to have "'exercised significant control over management or operations' or some variant of that." See Brief for Petitioners at 32-34. A fair reading of the opinion below shows that *Yellow Bus* merely was cited as an example of a decision that discussed the ostensible "inconsistencies between the circuits regarding the necessary level of participation for RICO liability." See *Arthur Young, supra*, 937 F.2d at 1324. After citing *Yellow Bus* for that limited point, the court adhered to the *Bennett* standard as written. See *Arthur Young, supra*, 937 F.2d at 1324. By juxtaposing *Bennett* and *Yellow Bus*, petitioners seek to construct a straw man "control" issue that would divert this Court's attention from the issue on which it granted certiorari. See Petition for Writ of Certiorari, at i. Petitioners also sought to interject the "control" issue in the question presented in their brief on the merits, even though no such issue was fairly included in the question on which this Court granted certiorari. See Supreme Court Rule 14.1(a). This change in the substance of the question presented (see Brief for Petitioners at i) is impermissible under Supreme Court Rule 34.1(a).

meaning accorded it by the court did endow it with content. In *Martino*, the Fifth Circuit's construction of the word "conducts" was drawn from *United States v. Tucker*, 638 F.2d 1292 (5th Cir.), *cert. denied*, 454 U.S. 833 (1981), which involved 18 U.S.C. § 1955—an entirely different statute from RICO. That statute penalizes one who "conducts" an illegal gambling business. See *Martino, supra*, 648 F.2d at 382.

Finally, decisions such as *United States v. Scotto*, 641 F.2d 47, 53-54 (2d Cir. 1980), *cert. denied*, 452 U.S. 961 (1981), and *United States v. Cauble*, 706 F.2d 1322, 1332 (5th Cir. 1983), *cert. denied*, 465 U.S. 1005 (1984), on which petitioners rely, cannot properly be read as addressing the statutory issue before this Court, much less as supporting a construction of the term "conduct" different from that adopted by the court below.<sup>17</sup> The "conduct" element of section 1962(c) was not at issue in *Scotto*; the defendant there was a high-ranking official in Local 1814 of the International Long-

<sup>17</sup> See also *Akin v. Q-L Investments, supra*, 959 F.2d at 533-34 and n.8 (incorrectly follows *Cauble* as controlling test for determining whether "a defendant participates in the conduct of an enterprise's affairs" for purposes of section 1962(c)); *Yellow Bus Lines, Inc. v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 952-54 (D.C. Cir. 1990) (en banc) (refers incorrectly to decisions interpreting § 1962(c)'s "through" element as decisions interpreting its "conduct" element), *cert. denied*, 111 S. Ct. 2839 (1991); *Heritage Ins. Co. v. First Nat'l Bank of Cicero*, No. 84 C 8747, 1985 WL 1872 (N.D. Ill. June 25, 1985) (same); D. Abrams, *THE LAW OF CIVIL RICO*, § 4.7.3, at 233-42 (1991) (hereinafter "*LAW OF CIVIL RICO*") (same); 9A Dep't of Justice Manual, ch. 110A, *Racketeer Influenced and Corrupt Organizations (RICO): A Manual for Federal Prosecutors*, at 83-88 (1991) (hereinafter "*Manual for Federal Prosecutors*") (same). The Department of Justice misunderstood *Scotto* and *Cauble* as decisions construing the "conduct or participate" element. See *Manual for Federal Prosecutors, supra*, at 84 n.172. *Scotto* construed only the "through" element. *Scotto, supra*, 641 F.2d at 53-54. In *Cauble*, the Fifth Circuit merely acknowledged that the "defendant-racketeering connection" and "enterprise-racketeering nexus" were separate concepts; the remainder of the court's discussion modified the *Scotto* "nexus" standard. See *Cauble, supra*, 706 F.2d at 1331-33, 1341. Therefore, petitioners and certain of the *amici* that support them are in error in relying on *Scotto*, *Cauble* and other "nexus" cases as decisions interpreting section 1962(c)'s "conduct or participate" element more favorably than *Bennett* or the decision below. See Brief for Petitioners at 40 n.16; Brief for United States at 9 n.7; Brief for NASCAT at 11-14.

shoremen's Association, the alleged RICO "enterprise." *Scotto, supra*, 641 F.2d at 50, 53-54. Nor was the "conduct" element at issue in *Cauble*; the defendant there was a general partner of Cauble Enterprises (the RICO enterprise), which gave him the "ability to dispatch the Cauble Enterprises airplane and to use Cauble Enterprises' assets to pay for commercial flights." *Cauble, supra*, 706 F.2d at 1341.<sup>18</sup> Thus, *Scotto* and *Cauble*, and decisions from other circuits construing a different element of section 1962(c),<sup>19</sup> are of doubtful relevance to the issue before this Court.<sup>20</sup>

18 In construing section 1962(c)'s "through" (or "nexus") element, several courts have adopted standards which contain elements similar to the Eighth Circuit's formulation of the "conduct" element in *Bennett*. The Ninth Circuit in *Sun Savings & Loan Ass'n v. Dierdorff*, 825 F.2d 187 (9th Cir. 1987), defined the "nexus" element as follows:

[A] nexus exists "when (1) one is enabled to commit the predicate offenses solely by virtue of his position in the enterprise or involvement in or control over the affairs of the enterprise, or (2) the predicate offenses are related to the activities of that enterprise."

*Sun Savings, supra*, 825 F.2d at 195, quoting *United States v. Scotto*, 641 F.2d 47, 54 (2d Cir. 1980), cert. denied, 452 U.S. 961 (1981). See, e.g., *A.G. Edwards & Sons, Inc. v. Smith*, 736 F. Supp. 1030, 1037-38 (D. Ariz. 1989) (following *Sun Savings*); *Richmark Corp. v. Timber Falling Consultants, Inc.*, 730 F. Supp. 1525, 1534 (D. Or. 1990) (same).

19 See, e.g., *United States v. Pieper*, 854 F.2d 1020, 1026 (7th Cir. 1988) (analyzing requisite nexus between racketeering activity and enterprise's affairs); *United States v. Horak*, 833 F.2d 1235, 1239 (7th Cir. 1987) (same).

20 In the United States' amicus brief in support of petitioners, the Solicitor General ignores the structure of RICO and attempts to collapse the separate "conduct" and "through" elements by urging that decisions such as *Scotto* and *Cauble* "integrate into a single inquiry the issue whether the defendant 'conducted or participated' in the conduct of the enterprise's affairs, and whether he did so 'through' a pattern of racketeering activity." Brief for United States at 9 n.7. While the proof to satisfy each element may overlap, see, e.g., *Turkette, supra*, 452 U.S. at 583; *United States v. Mazzei*, 700 F.2d 85, 89 (2d Cir.), cert. denied, 461 U.S. 945 (1983), and the standards governing the requisite degree of proof to satisfy each element may contain similarities, see, e.g., *Pieper, supra*, 854 F.2d at 1026-27; *Sun Savings, supra*, 825 F.2d at 194-95; *Cauble, supra*, 706 F.2d at 1331-33, the

(footnote continued)

For all of the reasons discussed above, the Institute respectfully submits that the "operation or management" standard is the correct standard for this Court to endorse. It will ensure that liability under RICO will be kept within legislatively defined bounds by requiring that RICO defendants have a significant degree of involvement in the affairs of a RICO enterprise.

## POINT II

### THE DECISION BELOW SHOULD BE AFFIRMED BECAUSE IT PROMOTES CERTAINTY REGARDING THE BOUNDARIES OF CIVIL LIABILITY IN COMMERCIAL RICO CASES.

Notwithstanding "the congressional admonition that RICO be 'liberally construed to effectuate its remedial purposes,'" this Court recently acknowledged its "fear that RICO's remedial purposes would more probably be hobbled than helped by [a RICO plaintiff's] version of liberal construction" that would allow suits to proceed in derogation of RICO's plain language, legislative history and statutory scheme. *Holmes v. Securities Investor Protection Corp.*, 112 S. Ct. 1311, 1321 (1992). This Court's recent decisions interpreting RICO by assigning primary importance to the words of the statute, its structure, and its legislative history, reflect the basic policy considerations that civil liability should be defined by the statutory language, read in context and confined within legislatively mandated bounds. See, e.g., *Turkette, supra*;

(footnote continued)

terms "conduct" and "through a pattern" remain separate elements which serve distinct statutory purposes, *Sedima, supra*, at 473 U.S. at 496. *Scotto* and *Cauble* do not hold otherwise, nor would the result in these cases have been different had the *Bennett* "operation or management" standard been applied. Indeed, in each of the cases cited by the Solicitor General as involving "characteristic applications" of RICO (see Brief for United States at 19), it can be said that the defendant had "some participation" in at least the "operation" if not also the "management" of the enterprise. See *Bennett, supra*, 710 F.2d at 1364.

*Sedima, supra*; *H.J., supra*. By urging this Court to reverse the decision below, and thus effectively to write section 1962(c)'s "conduct" requirement out of the statute, petitioners disregard these grave policy concerns raised by an expansive view of RICO liability.

#### A. Vexatious RICO Litigation Should Be Discouraged.

Although Congress enacted RICO to create a new, effective weapon in the war against the infiltration of legitimate businesses by racketeers and organized crime, it has become increasingly common for plaintiffs' counsel to view the primary purpose of a civil RICO lawsuit as a means to extract large settlements from legitimate businesses. See 137 Cong. Rec. E1219-02 (1991) (remarks of Rep. Hughes); Wright, *Why Are Professionals Worried About RICO?*, 65 NOTRE DAME L. REV. 983, 993 (1990). When legitimate businesses are confronted with civil RICO lawsuits seeking treble damages and attorney's fee awards some defendants are willing to settle even claims that have no merit; in this regard, "RICO has been used for extortive purposes, giving rise to the very evils it was designed to combat." *Sedima*, 473 U.S. at 506 (Marshall, J., dissenting), citing Report of the Ad Hoc Civil RICO Task Force of the ABA Section of Corporation, Banking and Business Law 69 (1985); see also Harrison, *Look Who's Using RICO*, 75 A.B.A.J. 56 (1990) (the "threat of an unsympathetic jury has pressured many defendants into settlement figures that were simply unheard of previously"). Justice O'Connor recently observed that, "[i]n addition to the threat of treble damages, a defendant faces the stigma of being labeled a 'racketeer[.]'" as well as "the very real specter of vexatious litigation based on speculative damages" when RICO claims are based on predicate acts of securities fraud. *Holmes, supra*, 112 S. Ct. at 1327 (O'Connor, J., concurring).

A statute which induces private parties to settle actions without regard for the merits of the claim undermines the rule of law. As noted above, some plaintiffs file RICO cases solely to extract a settlement and RICO claims are often set-

tled without regard to the merits. See Crovitz, *RICO: The Legalized Extortion and Shakedown Racket*, in *THE RICO RACKET* 15, 26-27 (1989); see also Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 568-70 (1991). A legal system that places a disproportionate monetary burden on defendants who are comparatively free of blame, but happen to have deep pockets, "dilutes the moral force of the law and breeds cynicism on the part of those deep pockets who are targets." Wright, *supra*, at 994.

#### B. Harm To The Accounting Profession.

Accountants have been particularly hard hit by the civil RICO litigation explosion because the services they provide cause them to be named in RICO lawsuits on a regular basis. See Gossman, *The Fallacy of Expanding Accountants' Liability*, 1 COLUM. BUS. L. REV. 213, 215 (1988); Wright, *supra*, at 992; Temes, *Firms Chasing Clients, Top Pros of Laven-thol*, Crain's New York Business, Nov. 26, 1990, at 1 (a number of accounting firms face potential liability as large or larger than bankrupt Laven-thol Horwath in large part due to RICO's treble damages provision). In part, this is due to the complexity of the certified public accountant's function and a pervasive misunderstanding of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards that some commentators have called an "expectation gap": "a difference between what the public and financial statement users believe accountants and auditors are responsible for and what the accountants and auditors themselves believe they're responsible for." Guy & Sullivan, *The Expectation Gap Auditing Standards*, J. ACCT. 36 (Apr. 1988). A related but separate reason why auditors are frequently named as defendants is that, "[f]rom [the public misperception of the auditor's duties] flows an erroneous legal supposition that [the auditor's] responsibility should be co-extensive with that of the client." Minow, *Accountants' Liability and the Litigation Explosion*, J. ACCT. 70, 77-78 (Sept. 1984).

Another reason why accountants have been particularly vulnerable to civil RICO litigation is that, in the current economic environment, it has become common for plaintiffs to bring RICO claims against accountants in their search for "deep pockets" when the accountants' clients enter bankruptcy or encounter financial difficulties: "Some investors and creditors automatically sue accountants and their firms when businesses fail without regard to what caused the failure . . . . There is an obvious lure in suing the accounting firms, for they are frequently the only solvent party left standing in the wake of corporate bankruptcy." Minow, *supra*, at 76. This problem also exists in the non-bankruptcy context, where investors in businesses bring lawsuits to recoup economic losses caused by an upheaval in the market or the improper actions of the accountant's client. See Wright, *supra*, at 991-92; Mednick, *Accountants' Liability: Coping With the Stampede to the Courtroom*, J. ACCT. 118 (Sept. 1987); Galen, *Litigation Blitz Hits Accountants*, Nat'l L.J., June 16, 1986, at 1, 26 col. 1. As one class action attorney explained, "[s]omeone has to pay when a person . . . invests in a company that goes sour." Berton, *Investors Call CPAs to Account*, Wall St. J., Jan. 28, 1985, at 30, col. 4.

One commentator on insurance insolvencies has referred to accountants as "preferred defendants" and counseled in favor of filing RICO claims against auditors as a means of inducing "an earlier and more favorable settlement[.]" Howard, *Making Accountants Account For Themselves When An Insurance Company Has No Tomorrows*, FICC QUARTERLY 342, 343 (Summer 1990). This type of advice demonstrates why RICO should not be interpreted more broadly than it already is, especially given the ease with which a RICO lawsuit against an accountant can be built "on a scaffolding of the merest guesswork and supposition, junk science and prejudicial tidbits." W. Olsen, *THE LITIGATION EXPLOSION* 289 (1991). It is therefore not surprising that, in the single year subsequent to *Sedima* alone, at least 22 RICO suits had been filed against small CPA firms who have AICPA insurance and at least 31 against larger firms. Galen, *supra*, at 27, col. 1.

The improper use of civil RICO threatens accountants with more than just economic harm. As professionals, accountants and accounting firms depend for their livelihood on fostering a reputation for careful, high-quality work. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990). In many instances, accounting firms feel pressured to settle RICO claims quickly because the mere filing of a RICO complaint can cause substantial harm to the reputation of an accounting firm, which is arguably its "most valuable economic asset." *O'Brien v. Price Waterhouse*, 740 F. Supp. 276, 280 (S.D.N.Y. 1990), *aff'd sub nom.*, *O'Brien v. National Property Analyst Partners*, 936 F.2d 674 (2d Cir. 1991). Excessive exposure to RICO liability even threatens to drive young and talented professionals away from the field of accounting, which in turn threatens the future of the profession. As an additional consequence, qualified individuals are declining to join accounting partnerships in ever-increasing numbers. See Cowan, *The New Letdown: Making Partner*, N.Y. Times, Apr. 1, 1992, at D1. If this Court adopts the expansive view of RICO offered by petitioners, it is certain that civil RICO liability will pose an even more serious threat to the future of the accounting profession than the grave threat it poses now.

### C. Harm To Users Of Accountants' Services.

Potentially indeterminate liability under RICO could limit or, in certain instances, eliminate the availability of high-quality accounting services. Some accounting firms may refuse to provide their services to smaller clients. One attorney who represents accounting firms presented the problem pointedly: "Why should someone do an audit that pays them \$25,000 and subject themselves to \$25 million in liabilities? No one in their right mind is going to do that." *Applicability of RICO to Accountants For Banks, S&Ls to Be Heard by High Court*, The FDIC Watch, March 2, 1992, vol. 2, no. 8, at 3. Moreover, accountants may also refuse to audit enterprises they perceive as risky. See, e.g., McCarroll, *Who's Counting?*, Time, April 13, 1992, at 48, 50 ("[A]ccounting

firms are abandoning the riskiest clients, most notably financial-services companies'''); Berton, *Legal-Liability Awards Are Frightening Smaller CPA Firms Away From Audits*, Wall St. J., March 3, 1992, at B1, B5 (accounting firms are turning down audits of public companies due to concerns that the work will lead to litigation); see generally Minow, *supra*, at 80; Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1962-63 (1988). It is not surprising that larger firms are wary of the potential damage to their reputation that even a meritless RICO action can bring and that smaller firms are concerned that they may not be able to bear the substantial costs of defending a RICO action.

RICO litigation against accountants may also result in clients' being unable to pay the increased costs of high-quality accounting services. As the Seventh Circuit recognized in *DiLeo*, *supra*, 901 F.2d at 629, an overbroad extension of accountants' liability necessarily increases the costs of accounting services and thereby decreases the availability of these services. Clients who are unable to afford the increased cost of high-quality accounting services may turn to accounting firms who are less responsible, but cheaper. See Kirby & Davies, *Accountant Liability: New Exposure For An Old Profession*, 36 S.D.L. REV. 576, 595 n.200 (1991).

#### D. Harm To The Capital Markets.

The unwarranted expansion of accountants' liability under RICO may chill the free flow of financial information from high-quality accountants to businesses and investors. See McDonald, *Accountants' Liability to Third Parties: Unmanageable Risks of Foreseeability*, DEF. COUNS. J. 194, 198 (Apr. 1990) (unlimited duty decreases incentive to conduct audits and decreases flow of economic information). This problem is a serious one because accountants play an integral role in the dissemination of financial information, and the dissemination of such information to the investing public is a primary goal of the federal securities laws. See Securities Act

of 1933, 15 U.S.C. § 77aa (Schedule A)(25)-(27); and Securities Exchange Act of 1934, 15 U.S.C. § 78l(b)(1)(J)-(K).

Furthermore, the capital markets, through which securities are traded and resources are allocated, function under the principle of "informational market efficiency." Jagannathan & Palfrey, *Effects of Insider Trading & Disclosures on Speculative Activity and Future Prices*, 27 ECON. INQUIRY 411, 427 (1989); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593 (1984); see *Basic Inc. v. Levinson*, 485 U.S. 224, 245-47 (1988). In an efficient capital market, firms can make production and investment decisions, and investors can choose among securities that represent ownership of issuing firms, under the assumption that security prices at any time fully reflect all available information. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (May 1970). This has been recognized for a considerable period of time. See Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172 (1933). A rule of law that inexorably tends to shrink the information available to businesses and investors by imposing exorbitant risk on its collection, analysis and dissemination, also tends to diminish the efficiency of capital markets. Such a rule embodies a very risky policy judgment and should not be fashioned by a court in the absence of a compelling legislative command.

#### E. Competition May Be Diminished.

The SEC has argued that the potential liabilities associated with civil RICO "impede capital formation" by issuers and may "discourage innovation by financial service providers," and thus, "put[ ] the United States at a competitive disadvantage by discouraging foreign involvement in our markets." *Statement of Mary L. Schapiro, Comm'r, SEC, Concerning RICO Amendments of 1991: Hearing on H.R. 1717 Before the Subcomm. on Intellectual Property and Judicial Administration of the House Judiciary Comm.*, quoted in 6 Civil RICO Report, at 1-2 (Apr. 30, 1991). One commentator has observed that expansive civil RICO liability can harm Ameri-

ca's competitive standing for the additional reason that accountants will be discouraged from implementing innovations within the accounting practice and from servicing "the kinds of new, daring entrepreneurial ventures that the economy so desperately needs, including experimental high-technology companies." Minow, *supra*, at 80. Again, the Court should not so interpret RICO as to run these economic policy risks when the statutory language and history so clearly do not compel it to do so.

### CONCLUSION

For all of the foregoing reasons, the judgment of the Court of Appeals for the Eighth Circuit, insofar as it affirmed the District Court's grant of summary judgment to respondent, should be affirmed.

Dated: May 29, 1992

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